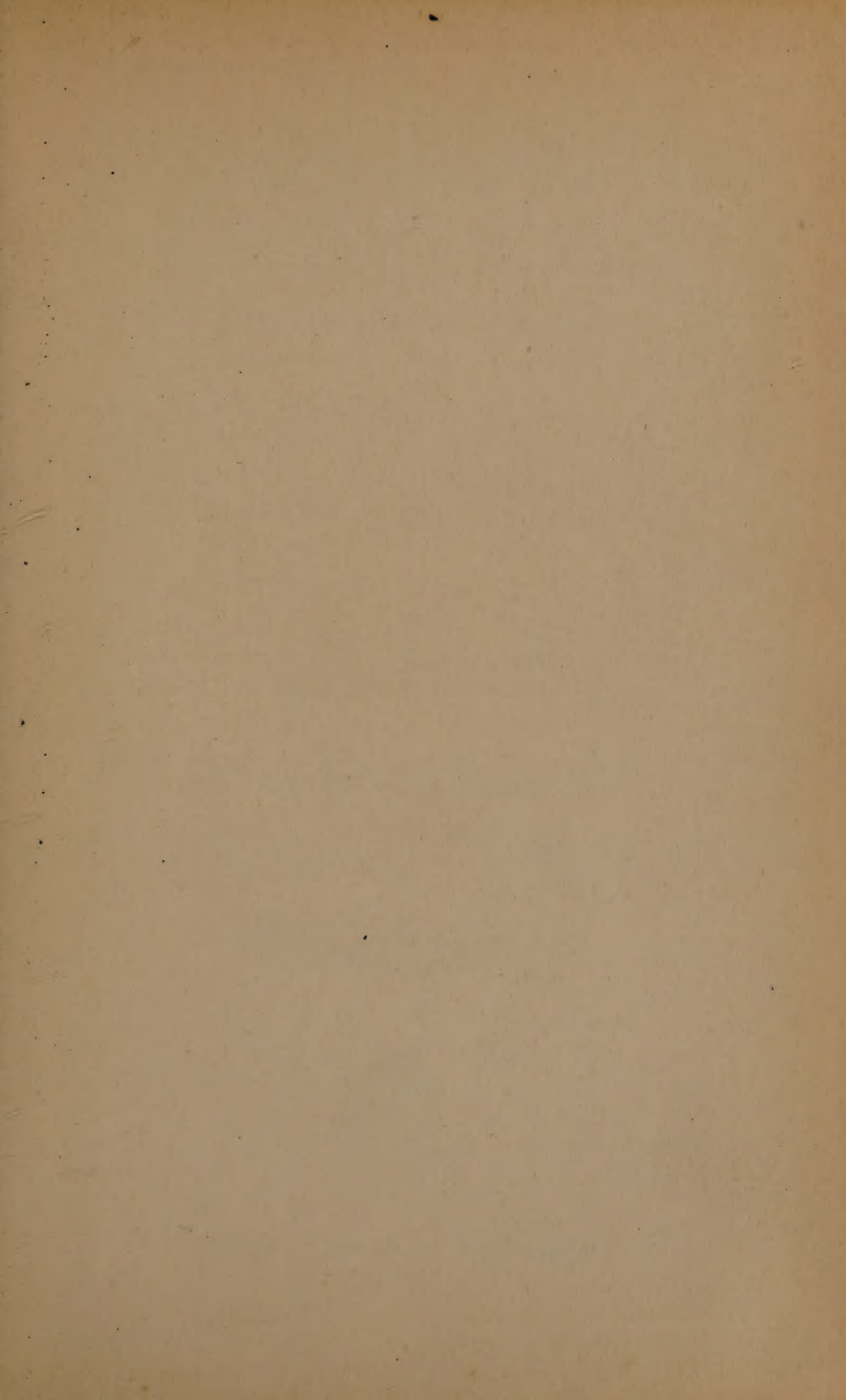




BUSINESS MANAGEMENT

Executive Manuals 91 and 92

PROCEDURE IN REORGANIZATION [I]—Being Executive Manual 91, on Organization and Reorganization, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
staffs of LaSalle Extension University*

Especially acknowledging the advice and co-operation, in
the various Organization and Reorganization manuals, of

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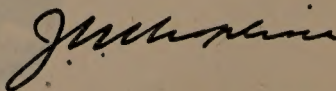
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PROCEDURE IN REORGANIZATION [I]

Part I

OPERATING ORGANIZATION

PROGRESS and improvement in business organizations of every kind and size may be attributed to two primary motives: first, the desire to adopt the means of earning better and more certain profits; second, the desire to consolidate all gains and prevent losses.

The first of these motives is progressive, continually causing us to reach out for new methods or for improvements in old methods. The second motive is conservative, causing us to embrace protective measures which enable us to ward off retrogression and failure.

What Is Operating Reorganization? The constant search for improvement and the desire for conserving gains, coupled with the necessity of meeting changing conditions incident to the growth of a business, are fundamental factors which tend to keep business organizations flexible. They make necessary, from time to time, changes in the operating structure of the business. These changes, if they are of considerable scope and importance, may justify the term, "internal operating reorganization."

Operating reorganization is the rearrangement or adjustment of the functions, methods, and processes of a business to insure smoother and lower cost operation, or to correct personnel difficulties.

The procedure followed in reorganizing an operating personnel and the procedure used in organizing an operating personnel are essentially similar. The main difference between the two lies in the fact that in organizing a new operating force we literally start from scratch and build up our organization from human material drawn

from outside sources. In a reorganization we readjust the duties of individuals within an existing organization; and we may in the course of such reorganization find it necessary to supplement, or supplant, some of the existing personnel by bringing in new members from the outside.

Altho we may find it necessary, in a reorganization, to bring in new men from the outside and perhaps displace some of the men in the old organization, we must remember that drastic changes of this kind are seldom advisable; and they must always be made gradually, after confirmation of mature judgment as to their advisability, if the business is to function during the period of reorganization without any great confusion or undue temporary loss of efficiency.

Organization—the Background of Reorganization. We saw, in Executive Manual 8, and also in Executive Manual 86, that a good organization is one in which there is a balanced, harmonious relationship between all the parts. We know that division of authority, delegation of authority, and delegation of responsibility are the three basic functions in building an organization. These three functions are effective, not only for the organizer, but also for the reorganizer, who, by properly discharging them, brings about better balance and smoother operation, both of which are essential to the more profitable conduct of the business.

Both the organizer and the reorganizer divide and delegate authority and responsibility with a view toward attaining maximum operating efficiency.

When we see operating organizations working smoothly and harmoniously together at top speed, with little evidence of confusion, we know that the basic functions of organization just mentioned have been well handled.

We can understand, thru our grasp of management principles, how the organization is controlled, but the question comes up—"How did it get started?"

It is true, of course, that some good constructive planning preceded the actual organization; and that once the plans were made, an orderly procedure was adopted to put the plans into actual practice. We also know that the plans were checked up while they were in operation, and that they were changed where advisable.

The planning and procedure used in organizing and managing a force are the best background possible for a study of reorganization. Let us see, therefore, what the organizer does when he starts an operating organization, and how he does it.

Determining the Objectives of Organization. When we say that the first step to be taken in forming an operating organization is to know definitely what is to be accomplished, it sounds like a statement of fact obvious to everyone. It is, however, one of those simple things that may be easily neglected in planning an organization; otherwise there would be less of reorganizing work to be done among business concerns.

The first question we must ask ourselves, either in organizing or in reorganizing the operating force of a business, is: "What is the prime object of the business as a whole?"

The answer, "To make money," doesn't really help the organizer. He must determine where the preponderance of activity lies. In some lines of business, such as the manufacture of steel, the preponderance of activity lies in production. In many others, office-appliance manufacturing, for example, the preponderant activity is selling. In some concerns, both of these activities seem to be of equal importance.

Before we can find and clearly fix in our minds the prime objective or objectives of organization, we must—

1. Determine the relative importance as a contributor to the profits of the business, of each major activity in the business.
2. Arrange these major activities in their degrees of magni-

tude as factors which contribute to the profits of the business.

3. State in considerable detail what procedure is to be followed in effectively maintaining these activities.

The Financing Consideration. When the organizer, or the reorganizer, has a clear conception of the relative importance of the main divisions of the business as related to the earning of profits, he is ready to consider the next point—the amount of money he has available to effect his organization or his reorganization. This question of available funds is very important. It may limit the scope of the organizer's plans, for his plans of organization or reorganization must not be such as to put a dangerous financial strain on the business.

It is well for the builder of a new organization to budget his expenditures, so that the expenses of organization and of operating the business until it is on a self-sustaining basis, will fall within the funds available for organizing the business and giving it a good start. He must, on the one hand, avoid planning too ambitiously; and, on the other hand, he must avoid planning an organization that is too weak, either in quality or in quantity, for accomplishing its purpose.

Formulating the Ideal Plan. As soon as the efficient organizer has a clear picture of what is to be done and an accurate knowledge of the funds at his disposal, he may then construct an ideal plan of organization. He will forget, for the time being, that he may have to change his ideal plan later on. But he should first put on paper the *best* way that the object of the organization can be attained—within the limit of funds available for carrying out the plan.

In formulating his ideal plan, the organizer must remember that—

Organization means determining the activity of each individual and group to be employed and establish-

ing their relationship and connection with one another for a definite accomplishment.

With this principle in mind, the organizer can begin to work out his organization on paper. If the new organization is that of a manufacturing plant, the organizer may first roughly divide his appropriation into two parts: the first part to take care of the purely manual and clerical activities; the second part to take care of the executive activities.

The amount to be set aside for manual activities can be determined by working out the cost of manual labor per unit of product, basing the figures on the cost of similar operations elsewhere. The problem of determining the cost of clerical labor is more difficult; but the total cost of this kind of labor in a manufacturing plant would, in all probability, be relatively small; therefore, determining this cost only approximately may serve the purpose. It would vary with the amount of record-control necessary; and this would, in turn, depend considerably upon the plan of organization; therefore, this cost would be susceptible to control, more so than manual labor.

Providing for executive supervision of operations is always, especially at the start, primarily a problem of securing the right men or women to fill the more responsible executive positions. The efficient organizer plans for fewer and better executive workers rather than for quantity, because these first executives must be the kind that can carry the business thru its first crucial operating experiences successfully. They must also be the kind who can develop in executive strength and become executives over other executives as the business grows in size.

Listing the Things to Be Done. Before the organizer can give any consideration to the number of persons he contemplates for his executive staff, he must list the various things to be done by his executive force. He must go into details and not be satisfied with such terms as

“supervise accounting” or “handle sales.” Each and every supervisory activity should be listed. The duties of a sales-promotion department were listed in Executive Manual 23. While these duties are largely clerical, that analysis gives some idea as to the extent to which a detailed analysis of executive duties should be carried.

After the organizer compiles this list of things to be done and thinks of the money he has at his disposal to get these things handled competently, it is possible that he will be struck by the thought that the task confronting him is an impossibility. But, remember, he is as yet working on an ideal organization and has not yet started his paring down or eliminative process.

Classifying the Things to Be Done. After the things to be done are listed, the next step is to group them into logical divisions, such as sales, finance, accounting, engineering, production, and administration. These logical divisions are not fixed hard and fast, but they are subject to expansion or contraction at the will of the organizer.

Naturally the grouping of these potential duties must be done with considerable discrimination; but general knowledge of the business, such as an organizer should have, enables him to determine readily the logical divisions of the business and to place each separate function under its logical division.

The Two Kinds of Control. Before we consider the problem of assigning duties to the members of our ideal organization, we must give consideration to two basic methods of control:

1. Line control.
2. Functional control.

These are different systems of transmitting policies and orders formulated by the management to those who execute these policies or orders. Let us analyze the attributes of these two systems as a means of establishing

the meaning of the terms so that we shall be able to use them later on in handling problems of organization and reorganization:

An executive has line control when he is charged with the responsibility of seeing to it that certain activities are actually performed.

An executive has functional control when he is charged with the responsibility of directing *HOW* a certain activity must be accomplished or of approving the methods developed by others.

Both of these methods of control may be exercised by one man. A personnel manager exercises functional control in every department of a business in so far as personnel matters are concerned. He exercises line control over the workers in his own particular department. He states *how* the personnel shall be employed and handled as to discipline in every department, but the executive who has line control over a department actually handles the working force in that department. Within his own department the personnel manager not only plans but actually sees that his plans are carried out, and thus the personnel manager exercises line control in his own department as well as functional control of employment in other departments.

Assigning the Duties. Before the organizer is in position to consider his organization as a whole, he must take the list of duties which he has grouped as mentioned before, and divide these duties among an executive personnel, giving no particular consideration for the time being to titles. In other words, if the organizer finds that those duties which logically fall under the sales division would necessitate the services of two executives, he should arrange these duties under two headings without being concerned as to the title of the men to whom these two groups of duties will fall.

In this matter of arranging duties it should always be remembered that—

Duties of a similar nature or those which are immediately contributory to each other should, as a rule, be grouped together.

If one duty is the analysis of sales possibilities, for instance, this duty may be grouped with others of a statistical or research character and not with duties of distinctly sales administrative character.

It is impossible to develop any fixed formula for the assignment of duties. This work of the organizer is largely a matter of assigning supervision of activities in the light of his knowledge of the probable capacity for doing the necessary supervisory work on the part of each executive whom he finds he must have in the organization.

When this grouping of activities has been completed, the organizer can then give his attention definitely to the executive staff that will be needed. He may then find that he has need for a greater executive force than the business can afford to employ. In that case the problem becomes one of removing one or more of the groups by placing the activities of those groups into other and fewer groups until he has reduced his need for executives to the point where the business can afford to hire them.

Determining the Organization Form. Let us review briefly what facts we have at our disposal when we attempt to decide on our tentative organization form. The following material is available:

1. A complete picture of what is to be accomplished.
2. A list of all the executive duties to be performed.
3. The above duties grouped in separate classifications.
4. The minimum number of executives needed to handle the duties given above.
5. A preliminary grouping of the duties assigned tentatively to each executive.

The next question which the organizer must consider is, "Can the objective of this organization be best attained

by rigid line control thruout the organization, or by the co-ordinated efforts of specialists acting in a functional capacity, in co-operation with line administration?" This question is answered, in part, by the man-management policy to be adopted by the general management, which policy is influenced by the inherent characteristics of the work to be performed.

It is difficult to formulate the best combination of line and functional organization. In deciding on this there are many different considerations that an organizer is called upon to weigh in the balance, of his judgment. There are, however, a few general guides which can be given; but it should be remembered that they are merely guides toward a solution and not hard and fast rules. These guides are:

In general, business activities which call for much technical or specialized operation are organized with a combination of functional and line control.

Business activities which involve simple production and marketing operations are usually organized on the line-control plan.

Another important factor for the organizer to consider in deciding on his organization form is the size of the business. If the beginning of the business is to be modest and the future growth is expected to be gradual and regular, a simple form of line control is preferable.

Line control is usually suitable for business activities of simple character and small in size. Line-and-staff, and functional control are usually more suitable to large and complex business organizations.

The Organic Form as a Factor. In the preceding manuals of this section, we have considered the characteristics of the several legal-financial forms of organization. We must recognize that this organic structure—proprietorship, partnership, corporation, or common-law trust—influences the form of the operating structure of the business in a very definite way. The proprietor of a business,

who must assume full personal liability, naturally wants to exercise as complete control over his business as possible; hence, we find that sole proprietorships are usually organized with line control. (A fuller description of line, line-and-staff, and functional control was presented in Executive Manual 34.)

Partners also wish to control their business closely, owing to their personal liability in case of failure, so we find that most partnerships, too, are organized on the principle of line control, but often with functional divisions as between the partners themselves.

Corporations, especially the larger companies, are usually organized so that the form of control most suitable to the requirements of various operations may be applied; in other words, the larger corporations usually adopt a combination of line-and-staff and straight functional control. Full and direct line control is usually confined in the corporate field to the smaller corporations or to large corporations in the early stages of their development when rigid control is more necessary.

The Organization Charts. Once the organizer has decided on the type of control to be adopted, he can proceed to the drawing of his organization charts. The first chart should show the titles of the executives in the proposed organization and the flow of their authority. Examples of this kind of chart are shown in Executive Manual 34.

The organizer has, as a basis for drawing this chart, the number of men who will comprise his executive personnel and the lists of the potential duties of each one, and he can arrange the flow of authority in line with the general system of control he has selected.

An organization chart should be carefully constructed to show the exact relationship as to authority among the executives of the organization.

After the organizer has drawn his organization chart showing the flow of authority, he should also draw a

functional chart, such as that shown in Executive Manual 34. This chart should list *all* the duties of *each* executive. When the organizer sees the various functions listed under the executives directly responsible for them, he can then study his assignments with a view to making sure that each duty or function will be placed in the best hands available.

The organizer should test the charts he has drawn by a critical application of his judgment on the following points:

1. Have I really centralized ultimate control?
2. Have I delegated authority co-extensive with the duties I have assigned?
3. Is my assignment of duties clear-cut so that there will be no question of proper authority?
4. Have I assigned just enough duties to engage the entire time of each executive without overloading him?
5. Have I clearly distinguished the difference between real executive functions and clerical duties?
6. Have I planned for effective co-ordination of activities?

It is always a good plan to take a hypothetical situation and try it out on a "paper organization" to test its working efficiency. This method often discloses serious errors in planning. It is also well to try a hypothetical case on your organization with one of the more important executives removed. This tests the flexibility of the organization and assures you that a temporary shifting of duties can be taken care of in an emergency.

As soon as the organizer has assured himself that his executive force is properly organized he can turn to his clerical and manual organizations and develop his plans for organizing them. Some organizers prefer to start with the manual organization first and then develop the executive force, but the procedure given above is preferable.

Finding the Right Men for the Organization. Now that we have our organization perfected on paper we come to the important duty of getting the men to fill the executive positions. We are not going to be concerned

here with the sources of supply of executives; we are only concerned with the method of finding suitable men for the organization.

Too many executives have been hired for new organizations just because they were executives, rather than because they had some special qualifications which exactly fitted the needs of the new organization.

It is more practical to find a man well suited to the duties than to attempt to adjust the duties to fit the man.

This principle is most pertinent in selecting executives for new organizations. We have seen that all the duties have been listed and grouped under the respective positions. The real problem is that of getting the right men to handle these groups of duties.

The plan of hiring a man and then saying that we will find the right place for him later on, is wasteful procedure; it is very likely to lead to an undue disruption of the original plan.

The organizer must remember, however, that in some cases it will be impossible to find a man with a record of past experience and training which covers every duty to be assigned to him, so it may be necessary to make some slight concessions in the organization plan. As previously mentioned, there must, in all probability, be some compromise between the ideal plan and the plan as actually adopted. These concessions should, however, be slight; the original plan should be adhered to unless there is no doubt about the advisability of a departure from it.

The Organization Policy. We hear much about "company policy" and we usually interpret it as meaning the policy of the company in its relation to the public or to its customers. "The customer is always right" states a policy applied by a company in its relation to customers. But we are here concerned, not with the policy toward customers or toward the public, but with the

policy governing internal relations between the executives of a business.

The main problem controlled by fixed internal policy is that of the division and delegation of responsibility. This problem, and the delegation of authority coextensive with responsibility, is, as we have seen, the fundamental task of an organizer. The internal policy defines the general attitude toward the delegation of responsibility.

The president who says, "I back up my executives' decisions to the limit," is expressing an internal policy which, when applied, has far-reaching effects. The executive who says to his subordinates, "Always see me on these decisions," is voicing another kind of policy. The executive who sometimes says one thing on this attitude and sometimes another, without apparent discrimination, really has no fixed policy.

The big question for the chief executive to answer in formulating his internal policy is, "Am I going to develop individuality and self-reliance or am I going to hold the reins tight?"

We find both of these policies working out well. There is little ground, in general, for stating which is the better of the two, apart from a specific set of conditions. But, in every case, a definite and known policy must be formulated and adhered to.

If an executive's responsibility and decisions are to be supported by the entire management, the knowledge of this fact will influence and strengthen his position.

If an executive's responsibility is known to be only nominal, his personal prestige will suffer and his decisions will lose much of their potency in the eyes of his subordinates.

Getting the Organization Started. Building a good operating organization is most difficult in the early stages. If the plan adopted weathers the storm of the first operating period, the organizer has every reason to feel that his plan is good; and the fact that the early stages

of operation put a hard strain on his organization should impel the organizer to take every precaution to make his plan sound and to give it a fair trial. He should see to it that—

Every member of the organization understands exactly what he is to do before operation is started.

It is obvious that the organizer cannot see each member of the new organization simultaneously and acquaint him with his duties, but simultaneous operation is what the organizer must have. Everyone should start handling his full duties at once. This requires a period of preliminary training, acquainting each man with his duties, one at a time so far as possible, before operations actually begin.

The best way to get simultaneous operation is to prepare a separate list of the duties attached to each position and deliver a copy to each member of the organization; not merely a generalized statement of what he is to do, but a detailed list similar to the list used in planning the organization. This list of duties should be accompanied by the organization chart showing the flow of authority and indicating clearly to whom each individual must look for instruction and advice.

A complete organization chart, properly drawn up, will give each individual a comprehensive picture of the organization as a whole and the part he plays in it.

In addition to the list of duties and the chart, each individual should receive a brief outline of company rules and policy, so that there can be no question of complete understanding on the part of everyone. A detachable form, acknowledging receipt and understanding of the information, is often used. An acknowledgment is signed by the recipient and forwarded to the personnel department or to the organizer.

Now that we have a review of organization procedure as a basis, let us take up, in the next part of this manual, the problem of internal operating reorganization.

PROCEDURE IN REORGANIZATION [I]

Part II

OPERATING REORGANIZATION

WE SHALL see that the procedure in operating reorganization has much in common with procedure in operating organization. Much of operating reorganization, in fact, could just as well be called operating organization; and as the work of organization progresses, there is considerable reorganization to be done from point to point.

Meeting Changing Conditions. While it is true that an organizer, in making his original plans, should give careful attention to the probable future development of his organization and provide for foreseeable contingencies, there are some contingencies that are bound to arise which cannot be provided for very far in advance. There are, for instance, changes in general business conditions, as explained in Executive Manuals 3 and 4, to which an individual business organization must be adjusted from time to time. In some cases, these changes in economic conditions are so drastic as to make internal reorganization necessary. The general business depression of 1920-1921, for example, was the cause of many internal operating reorganizations, particularly on the part of business concerns that did not look ahead and anticipate that great depression.

Wise management adjusts its internal organization to meet changing economic conditions; and these adjustments may necessarily be so drastic as to warrant calling them reorganization.

The Reasons for Reorganization. There are several reasons, in general, for the necessity of internal operating reorganization, one or more of which may be sufficient to bring about the need for reorganization. They are:

1. Expansion.
2. Retrenchment.
3. Death or retirement of a principal executive.
4. To remove internal friction.
5. To increase operating efficiency.

While an organization may have enough flexibility to adjust itself readily, without what is called a reorganization, to almost any amount of expansion or retrenchment, in actual practice such flexibility is rarely if ever found. If expansion or retrenchment is unusually rapid and extensive, it will, as a rule, give rise to the necessity for changes in the organization that are so drastic as to warrant the term "reorganization."

A rapid expansion usually puts a great strain on an operating organization, and often a breakdown can be avoided only by a general rearrangement of the duties and functions of the members of the organization. A well-organized business can seldom be expanded without limit simply by increasing the working force. Particularly if a business has been started with line control, it will find difficulty if it attempts expansion while retaining full line control. Under line control, the jobs of many of the executives, as the business expands, become unwieldy, and the various activities which a line executive must control become too much for his capacity. Reorganization which modifies the kind of control employed becomes necessary.

The tendency of change as a business expands is from line to line-and-staff and functional control.

Retrenchment also presents a problem that must often be solved by reorganization. When the management of a business faces the problem of having a large organization with insufficient work to keep it busy, a mere reduction in the working force will still leave an executive organization with many departments or functions which it may be profitable to eliminate. The problem of reassigning duties and absorbing the functions of the dis-

continued departments places a strain on the remaining force, and a reapportionment of authority and responsibility will do much to relieve the strain.

Reorganizations Caused by Death or Retirement. Another common cause of reorganization is the death or retirement of some important executive in a business concern. At first glance we might say that it would be comparatively easy to get some one to step into the retiring executive's place and administer his duties; but, in actual practice, it is often difficult to find a person with the necessary qualifications.

Here is a case that shows what a widespread disturbance the retirement of a major executive may cause in a business, and how reorganization offers a solution for these difficulties:

A hardware corporation had evolved from a partnership; the more active partner being made president of the corporation. This man, who was also the major stockholder, had carried into the new corporation his idea of having a highly centralized control; he had delegated little authority to anyone else in the corporate organization. He himself not only had complete control of all financial matters, but he also directly managed all of the sales activities.

The business of this corporation grew by leaps and bounds, but the president would not let go of any of his prerogatives. Under the great physical and mental strain, this man finally suffered a physical breakdown and had to retire. The board of directors looked for a man who could shoulder his burden of responsibility, but no one with the necessary qualifications could be found. While the directors were trying to find a man, sales began to fall off and a state of confusion within the operating force developed.

A reorganizer was called in to straighten things out. He made a survey of the situation, soon found the basic

cause of trouble, and, by carefully splitting up most of the former president's functional duties and distributing them over the existing executive force, brought order out of chaos and assured future operating harmony. With the burden of the former president's duties well distributed, it was a simple matter for the board of directors to elect a president to handle the general supervisory control of the business.

Eliminating Internal Friction. A common objective of internal operating reorganization is the removal of operating friction within the organization.

While it might seem that any internal friction could be eliminated gradually, sometimes resolute and swift reorganization is needed to correct the trouble and restore efficient operations.

When internal friction develops between departmental or functional divisions of the business, some executives are too much inclined to believe that this friction can be eliminated by removing some man from the organization and replacing him with some one else. This may now and then be true; but, while the personality of an executive does have considerable influence for or against the development of friction, the cause of internal friction in an organization usually lies deeper than in the personality of any one man. It may be that the true cause of friction lies in an unscientific division of responsibilities, with overlapping of authority.

Increasing Operating Efficiency. In many cases, an executive is inclined to believe that because his original organization plan worked well at one time it will work just as well all the time, and that therefore discord in his organization is the fault of some one or more of his men. As a result, men are discharged—and consequently the morale of the organization is likely to suffer.

There should not be unwarranted veneration for a plan of organization that has been successful in the past but has outlived its usefulness.

This weakness is not uncommon, and it often takes impending failure to bring executives to the realization that the old plan must be scrapped and a new and better plan substituted.

The executive who is confronted with a reorganization problem must bring to the consideration of his problem a critical and unbiased attitude.

It is usually difficult for an executive who has grown up within an organization to get the critical, detached viewpoint so necessary in effective reorganization work. To overcome this difficulty, internal operating reorganizations are often carried out under the direction of a trained man brought in from the outside. An outside man can more easily approach a reorganization problem without any personal bias or predetermined conclusions as to what the real difficulty is or how the trouble can be corrected. He is more likely to get at the actual facts of the case.

Selling the Executives on the Reorganization. Before the man in charge of the reorganization proceeds to the actual analysis of the problem confronting him, he should lay the groundwork and get general acceptance of himself and his ideas.

The organizer must remember that there may be considerable resistance to his organization plans, within the existing organization.

Recognition of this fact makes it imperative that the man in charge of the contemplated reorganization first sell himself and the need for reorganization to all the executives of the company. This can often be accomplished by asking for their suggestions in formulating the plan of reorganization; for—

When a man feels that he is playing or has played an active part in the formulation of a plan, he will be inclined to give his whole-hearted support to it.

As soon as the organizer is assured that he has won the confidence of the executives of the business in himself and his plan of reorganization, he can proceed with

this actual work of reorganization, perhaps with the help of a committee on reorganization chosen from among the executives of the business.

The Use of Committees in Reorganization. To help gain general acceptance of a reorganization plan among the executives of a company, it is often found that a reorganization committee is advisable. This committee is usually made up of certain staff and line executives, with the man in charge of reorganization as chairman.

The following committee is representative of many that are used by corporations in an internal operating reorganization:

- Industrial engineer (chairman).
- Assistant to president.
- Production, or works, manager.
- Personnel manager.
- Auditor or assistant treasurer.

The sales manager is not, ordinarily, a member of the committee unless some important questions as to sales or sales agencies are involved; but in every case, he is kept informed about the work of the committee on all matters that may affect sales policy or methods.

A reorganization committee brings to the assistance of the man in charge of reorganization a group of specialists each of whom is in intimate touch with operations in a major division of the business. The different viewpoints of these men will serve to prevent any undue consideration or lack of consideration of the interests of any of the various parts of the business organization.

Much responsibility, however, rests upon the chairman of the reorganization committee.

A reorganization committee should always have a well-informed, responsible chairman to keep the operations of the committee on the right track and to prevent unimportant considerations from engaging its attention; also to keep it from taking steps that will not work out practically.

Fixing the Objective. We saw in our discussion of the fundamentals of organization that before an organizer can make any progress, he must know what is to be accomplished. This is just as important in reorganization.

The man in charge of a reorganization must first establish his definite objective or objectives and then make every move count toward attaining them.

The organizer can best determine his principal objective by examining the conditions which created the need for reorganization. If an unexpected volume of business is straining the capacity of the present organization, or if an organization is inadequate to handle periodic peak loads, the organizer's objective is to provide a reserve of strength to be called upon when needed. This may be accomplished by having the executives train understudies who at times can take certain responsibilities off the shoulders of their principals. As pointed out before, a nucleus of trained executives can expand the scope of their own personal direction of activities only to a limited degree; beyond this limit, expansion of a business requires additional men for responsible positions.

If the need for high-speed operation discloses an unwieldy and cumbersome organization unadapted for sustained effort on a larger scale, the organizer's objective is to reassign and co-ordinate duties and make such changes in the personnel of the management as will assure effective control of high-speed operations.

But an organizer is not concerned, during the early period of reorganization, with the basic cause of the difficulty. He must rather be concerned, first of all, with the assembling of the data necessary for a complete analysis.

Where the reorganization has been prompted by a desire to increase general efficiency—where there is no definite trouble or difficulty to be corrected or avoided—then, of course, the organizer's job is not that of a

reorganizer so much as that of an organizer engaged in the work of perfecting his organization along lines already established. He may especially be interested in job analysis as a means of increasing efficiency by a better adaptation of men to their work.

The Job Analysis. Job analysis affords an excellent opportunity to find out just what is being done by each person in an organization; then to determine what kind of man can best handle each job.

Even the executive who has spent many years in an organization can learn much about his organization as a result of job analysis. Executive responsibility often creates an attitude of detachment toward the operation of an organization, but job analysis brings to the executive an accurate picture of his organization as it functions in its minutest detail.

Just as a small leak can eventually sink a big ship, so can a minor difficulty in a business organization, if uncorrected, cause major difficulties that may wreck a business; or that will at least eat into net profits.

An organizer or executive who is only concerned with major operations is often overlooking the basic cause of difficulty.

Job analysis may be applied to all kinds of jobs, from the highest to the lowest. There are two general procedures used in job analysis for reorganization purposes: by interviews and by questionnaires.

When the interview method is used, trained interviewers see each employe in person, and ask certain questions about his work, writing the answers down on a form designed for that purpose.

The success of a job analysis made by interview depends much on the degree of confidence established between the interviewer and the employe.

When the questionnaire method is used, each employe is given a form on which certain questions are asked, and

the employe is requested to fill out the form and return it to the man in charge of reorganization.

Which Method of Job Analysis to Choose. The organizer who has to get his facts quickly and at a low cost will do well to adopt the questionnaire method. Under this method all the facts are assembled simultaneously and analysis can be started at once.

The basic objection to the questionnaire method is that the employe is not usually inclined to give all the details asked for on the blank, particularly if such facts are open to interpretation adverse to the management. This resistance can be partially overcome by the assurance that the information is to be kept secret; but the organizer must take the factor of reticence into consideration in deciding what method of job analysis to use.

The interview method, thru its secrecy and thru the confidence the interviewer obtains, is a favored method when questions of policy or antagonistic personalities are involved in the job analysis.

The main objection to the personal-interview method of job analysis is its cost and the length of time it consumes. The interviewers must receive a preliminary training and, under ordinary circumstances, cannot interview more than eighteen or twenty employes in a day.

Job-Analysis Requisites. The first thing to do either under the questionnaire or the interview method is to assure the employe that his statements will be held in strict confidence and that the information he discloses will be used for organization purposes only and will not be disclosed. Once this assurance has been given, information should be obtained on the following points:

1. The title of the position.
2. Department.
3. The salary obtained.
4. Detailed outline of duties:
 - (a) Supervisory.
 - (b) Routine.
5. Number of employes supervised.
6. Title of immediate superior.
7. To whom employe reports.
8. Employes reporting to him.

- | | |
|-----------------------------------|---|
| 9. Source of orders. | 13. Could he function better elsewhere? |
| 10. Source of instruction. | (a) Where? |
| 11. Satisfied or dissatisfied. | 14. Complaints. |
| (a) Why? | 15. Suggestions for betterment of organization. |
| 12. Extra duties he could handle. | |

Those fifteen points are only a general outline; they can be contracted or expanded to meet particular conditions. Plenty of space or time should be given on questions 4, 11, 12, and 15, in order to encourage employes to go into detail in their statements.

As soon as the man in charge of reorganization has assembled all the job-analysis facts from all employes, he then assorts this information by departments.

Questions 7 and 8 should be compared with the rest of the departmental questionnaires to find any overlapping of authority. If the statistician, for example, answers question 7 with the name sales manager, and question 8 with the names of assistant statistician, manager of Hollerith tabulating department, and sales analyst, the questionnaires of all the men mentioned should be compared to see if the answers agree. Thus the answer to question 8 on the sales manager's questionnaire should agree with the statistician's answer to question 7; and the answers to question 7 of the assistant statistician, the manager of the Hollerith tabulating department, and the sales analyst should agree with the answer to question 8 on the statistician's questionnaire.

If any discrepancy is encountered in this comparison, inquiry should immediately be made to find out the true status of the employe.

The Organization Chart. When the accuracy of the questionnaire or interview slips has been checked, the organizer can draw his organization chart of the existing organization, showing the lines of authority, and the functions.

It is not necessary in all cases to make the chart so that it includes every employe. If the problem is one of co-ordination of activity, an arbitrary line of authority, say at the level of foremen and departmental chief clerks, may be established, and no functions given below that line.

Once the organization chart is drawn, the man in charge of the reorganization has a real basis on which to start his analysis. He should carefully examine the chart and test it by the questions and hypothetical cases given on page 11 in the first part of this manual. Any divergencies from accepted organization principles and practices should be noted.

Complaints and Suggestions. The next step is to check over and tabulate the complaints, grouping them roughly under suitable headings, such as:

1. Personalities.
2. Salaries.
3. Opportunity for advancement.
4. Monotony of work.
5. Physical conditions.
6. Security of employment.
7. Control of work.

This tabulation of complaints will give a good cross section of the personnel morale. If desirable, a further refinement of analysis may be introduced by dividing the complaints into two kinds.

1. Those made by executives and subexecutives.
2. Those made by workers.

Next a tabulation of suggestions may be made, first eliminating any purely fanciful or impracticable suggestions. Suggestions that are practicable should be appraised as to their value in the light of the general standing of the person making the suggestion—remembering, however, that the most valuable suggestions may come from employes of little standing in the organization.

Practical suggestions made by employes for improving operating efficiency are of considerable value to the organizer in planning his reorganization.

In fact, the key to a real solution of the reorganization problem may be embodied in one or more of the suggestions made out of the first-hand experience of employes.

Constructing the Reorganization Plan. There are very few organizations existing which cannot be improved, but minor improvements cannot be considered as coming within the meaning of the term "reorganization." Reorganization implies a major change in the operating structure of a business, and it is only with these major changes that we are here concerned.

When the man in charge of a reorganization has the facts at his disposal properly classified and arranged, he should construct the theoretically ideal plan of organization mentioned in the first part of this manual. His reorganization plan will consist of the ways and means of shaping the existing organization into approximate conformity with this ideal plan of organization. In remolding the old organization, there are four considerations which play an important part:

1. Time.
2. Personnel.
3. Expense.
4. Maintaining operation during the transition.

The organizer should estimate definitely the shortest time in which the change can be satisfactorily made, and plan to do it in this length of time; for he must have as little operating disturbance as possible in making the changes.

A leading question as to personnel changes is, "Can I use all the present personnel in my new plan or must I increase or diminish the working force?"

If more men are needed, plans should be made to obtain only men of suitable qualifications. If some of the present organization are to be eliminated, the man in

charge of reorganization should confer with the personnel manager as to who should be eliminated; in fact, close co-operation with the personnel manager thruout the reorganization on all phases of personnel changes will do much to smooth the ground for the success of the reorganization.

The question of expense must be weighed against the probable advantages of the new plan, and comparative operating figures should be made.

As we pointed out previously, the transition from one method of operation to another in a reorganization cannot be made over night and a very definite operating procedure should be outlined to maintain production during the period of reorganization.

It is imperative that all reorganization plans be worked out in detail and so prepared and carried out that operating procedure will be least unsettled by the changes that are made.

Once the plan is thoroly worked out, it should be prepared in the form of a report and submitted to the general management of the business for approval.

The Report to the Management. Considerable time and effort should be spent on the report of the proposed plan of reorganization, because this report will be the basis of the management's decision as to whether or not to accept the plan.

This report should embrace the following points:

1. The old organization in detail.
2. The basic objection to the old plan.
3. Why reorganization is necessary.
4. How reorganization is to be effected.
5. The new organization in detail.
6. The cost of the reorganization.
7. The expected savings from increased efficiency under the new plan.

Merely presenting facts and conclusions is not ordinarily sufficient if the report is to convince the manage-

ment that the submitted plan is the one to accept. The whole report should be written with keen appreciation of the natural resistance to decided changes that the present management of the business is likely to feel. Personal bias should not enter into the report, nor should any statement unsupported by facts be introduced.

In Part III we shall take up ways and means of carrying out a plan of reorganization.

PROCEDURE IN REORGANIZATION [I]

Part III

PUTTING THRU THE REORGANIZATION

WHEN the reorganization plan has been approved by the management and authority to put it thru has been granted, the man in charge of reorganization should start his second selling campaign. We remember how necessary it was for the reorganizer to sell himself and the need for reorganization to all the executives; now he must again exert sales effort to get general recognition and acceptance for the reorganization plan on the part of all who will be affected by the carrying out of the plan.

This selling of the plan calls for tact because, as a rule, executives and employes are very jealous of their prerogatives and the reorganizer who plans to take away any of these prerogatives without first showing why this change in authority will be beneficial to those concerned, is going to encounter a resistance which may seriously impair his success.

The human factor is a consideration which the reorganizer should constantly remember thruout the installation of his improved system of operations.

Meeting Resistance to the New Plan. A large manufacturing company secured control of a smaller company which supplied certain parts that entered into the product manufactured by the larger company. The executives of the larger company believed that there was considerable duplication of activity in the two separate organizations and that a considerable sum could be saved by consolidating the management and operations at these points.

A study was made of the situation and a reorganization plan was proposed whereby the total supervisory force

could be cut about 30 per cent thru consolidation. As an example in meeting resistance while putting this plan into effect, let us consider the case of one executive, who was the purchasing agent of the smaller company.

This man had been functioning effectively in his job over a period of years; he had come up from the ranks; but the reorganization plan demanded that the two purchasing departments be consolidated and placed under the supervision of the present purchasing agent of the larger company. No position of assistant purchasing agent was contemplated in the new plan. Apparently, there was nothing to do but to let the purchasing agent of the smaller company go.

The reorganizer recognized that if this was done it would have a very adverse effect on the whole organization; it would suggest that good service and faithful effort was receiving no recognition. This is certainly the impression which the purchasing agent would have gained had he been dismissed. The reorganizer also saw clearly that duplication of purchasing effort would, if allowed to continue, be anything but efficient organization practice.

Understanding both sides of the problem, he went to the purchasing agent affected and said, "You have been with this company a number of years and I know the management appreciates your service and effort. That is why I have come to you to ask your opinion as to where you could function best in our new organization plan. I don't want you to consider the position of purchasing agent in the larger company because I feel that your experience has equipped you with knowledge which would make you more valuable in another sphere. What do you suggest?"

Here was no implication of dissatisfaction, no attitude of "find a job for yourself or get out," but a tactful prompting of the purchasing agent's imagination. What was the result? That purchasing agent made an effort

to find for himself another position in which he could function effectively—without dissatisfaction but, on the contrary, with a feeling of gratification that his abilities were recognized.

A reorganizer can never afford, in his own interest, to ride roughshod over the sensibilities of the people affected by his plans.

Announcing the New Plan. After the reorganizer has paved the way, so to speak, for the reorganization by a tactful handling of the people vitally affected, it is usually the practice to have the management announce the proposed changes. In addition to the general announcement, each department head is furnished with a complete set of instructions as to what he is to do to bring his department in line with the new plan.

If the reorganizer's report has been complete, there should be no difficulty in transcribing from the report a detailed list of instructions for each department head.

In practice, it has been found that a mere statement of the objective of a reorganization is not sufficient information for a department head to shape plans on; but that complete procedure should be furnished to him.

If loose or general, rather than specific and detailed, instructions are given to a department head, he will very likely introduce some variations from the reorganization plan on his own account and thus cause difficulty. The reorganizer can never forget that he is working, not with inanimate blocks which can be arranged at will, but with human material of keen sensibilities that must be considered at every turn.

A very definite time must be set at which the changes from the old operating system to the new must be completed. This definite time limit furnishes a specific goal to be attained and practically assures, if the reorganizers' plans are correct, that operations can be commenced on the new basis simultaneously.

Instructions to Department Heads. Following is an example of reorganization instructions to a department head:

Inclosed herewith you will find an organization chart setting forth the new lines of authority and duties which it has been decided to adopt. We suggest a detailed study of this chart to familiarize yourself with the new plan.

You will probably note some changes from your present duties and those of your department. The following changes in duties concern you and your department. These changes are to be completed by August 31, at which time operations under the new plan will start.

You will assume the following responsibilities:

- Supervision of sales-promotion activities.

- Supervision of mailing list and files connected therewith.

- Supervision of local sales force under authority of sales manager.

- Supervision of salesmen's and departmental expenditures under authority of sales manager

You will be relieved of the following supervisory duties:

- Supervision of daily, weekly, and monthly sales reports.

- Supervision of market-analysis activities.

- Supervision of all graphic sales-presentation work.

Please transfer the following employees to departments indicated as follows:

- Assistant statistician to central statistical department.

- Statistical clerks (2) to central statistical department.

- Draftsmen and tracer to central statistical department.

- File clerks (2) to voucher section of auditing department.

Please have all statistical equipment and files transferred to central statistical department (Room 702).

These changes will necessitate adding to your present office force the following employees as of September 1.

- Two correspondents.

- Four stenographers.

- Two general clerks.

Equipment required for these additional employees will be provided before September 1.

Kindly acknowledge receipt and understanding on form attached.

John J. Talbott,
General Manager.

Such detailed instructions leave little chance for change in the hands of the department head; they are specific. When such instructions are co-ordinated with similar instructions issued to other department heads, the result is co-ordinated activity in putting thru the reorganization.

The Lists of Duties. A complete list of duties for each executive is, as we saw in Part I of this manual, very helpful in getting a new operating organization under way. Such a list of duties is also important in a reorganization, to show everybody not only what is to be done but also to show, briefly, just how the new duties are to be handled. A list of one man's duties, as used in a reorganization put thru by one very successful organizer, was as follows:

Duties Pertaining to the Position of Sales Statistician. Mr. Caldwell—You will have the following duties:

- Daily:
1. Render report of gross sales of each commodity to the sales manager on form provided, S-628. Attach 3 carbon copies; retain one for your file. (Source of material to compile report: auditing department forms A-528, A and B.)
 2. Check salesmen's daily reports, S-125, and tabulate reported sales, calls, and expense, and turn over leads and pertinent comments to sales-promotion department, retaining originals in your files.
 3. Render report to sales manager of stocks on hand of each commodity, showing daily average stock, with comparisons for week previous and month previous, on form provided, S-286. (Source of information to complete report: manufacturing department forms, M-625, M-627, M-629.)

- Weekly:
1. Recap. of forms S-628, daily sales.
 2. Recap. of forms S-125, salesmen's daily reports.
 3. Tabulation of discrepancies between reported sales, S-125, and actual sales, S-628, for each salesman.

4. Recap. of average of forms S-286 for week, compared with previous week and month.
5. Carbon copies of all letters written to salesmen, with their replies.

Reports 1, 2, 3, and 4 to sales manager. Report 5 to sales-promotion department.

- Monthly:
1. Monthly sales form, S-42 (Recap. of S-628).
 2. Form S-42 analyzed as to salesmen and district sales.
 3. Total sales expense. (Compiled from pay roll form, A-729, and salesman's daily report, S-125, plus overhead to department, A-49).

All monthly reports to sales manager.

You will supervise and assign duties to the following persons:

One assistant sales statistician.

One file clerk.

You will report directly to the sales manager and receive instructions from him. Functional control will be exercised on personnel matters by the personnel manager and on filing by the central filing superintendent.

We can see from the above that the man who took over these duties—Mr. Caldwell—knew just what he was expected to do; and he required very little in the way of personal instructions.

Operating under the New Plan. The organizer can hardly expect that his new organization plan is going to function perfectly at once. No matter how carefully he has planned, there is always the possibility of his having overlooked certain matters which must be taken care of by an adjustment after the plan is in operation.

One of the common causes of difficulty in operating under the new plan is that the ability and capacity of certain executives and workers proves to have been overestimated. If people are found to be unable to carry the responsibilities assigned them, the reorganizer should judge the matter dispassionately, and determine if the fault lies in too much work or in too little capacity on the part of the worker. Adjustment can then be made in the light of this judgment.

An organizer must be willing and able to readjust his plan of organization or reorganization in the light of deficiencies which are brought to light thru putting the plan into operation.

An organizer must be particularly attentive to the readjustments during the early stages of operations under the new plan. As a matter of fact, a reorganization is not complete until it has been clearly proved that the objectives of the reorganization have all been attained, with harmonious and profitable operation of the plan assured.

The early stages of operation under the new plan should receive exceptionally careful attention. The difficulties should be corrected as soon as possible, because the reorganization will be judged largely by its early operation. It is in these early stages that resistance develops and the latent hostility of members within the organization comes to the surface. The "I told you so" impulse is strongest in these early stages, and the man in charge of reorganization must give every care to see that his willing critics in the organization have no real basis for dissatisfaction.

* * * * *

Many of the details incident to internal operating reorganization have been covered elsewhere in this business-training service, particularly in the section on principles of production, where we thoroly analyzed organization along scientific lines. For, as we have seen, operating reorganization is essentially the same problem as that of organization. The problem of reorganizing the legal-financial form of a business structure is covered in the next and final manual of this section. First, however, you will want to work out the interesting problem, here presented, on "Reorganizing the Executive Staff."

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

1. An organizer was confronted with the problem of providing proper supervision for credits and collections. He decided to put credit and collection activities under the supervision of the sales manager on the theory that they were complementary to sales activities. Was this a wise decision? ☐ Yes. ☐ No.

2. In a business which depended largely on its chemical and mechanical engineering departments for success, would you recommend straight line control as the most suitable method? ☐ Yes. ☐ No.

3. The president of a company in which line control was used, stated that an organization chart was of little advantage because all the department heads reported to him. Was this sufficient grounds on which to reject the chart? ☐ Yes. ☐ No.

4. A general manager who had a policy of rigid line control and reserved all the important decisions for himself, felt called upon to censure a department head for laxity of control over this department. The department head offered the explanation that he could not control his force when they knew he had only nominal authority. Who would you say is most at fault: the general manager? ☐ or the department head? ☐

5. Would you consider it advisable to have the works manager as a member of the reorganization committee if difficulties in the departments under his control had been the cause of the reorganization? ☐ Yes. ☐ No.

6. The morale in a company about to undergo reorganization was low. The chief complaints were against the activities of the general manager. As a reorganizer in this case, would you be inclined to adopt the interview method of job analysis? ☐ Yes. ☐ No.

7. Would a reorganizer be justified in rejecting a suggestion for improving sales because it came from a bookkeeper in the auditing department? ☐ Yes. ☐ No.

8. "We shall have to reorganize our whole operating procedure," the president reported to the board of directors of the Bigelow Mail Order House, "and I recommend that Mr. Dilling, our office manager, be placed in charge of the reorganization committee."

"We would rather have you head that committee," spoke up one of the directors.

"No," said the president, "I am concerned with the major policies of the business. Mr. Dilling knows the details of our internal operating procedure better than any man we have."

Do you agree with the president? ☐ Yes. ☐ No.

Executive Problem 91

REORGANIZING THE EXECUTIVE STAFF

A Study of Jobs and of Men and a Plan for Fitting Jobs and Men Together

UNDER THE LASALLE PROBLEM METHOD



THE law of the "survival of the fittest" works in the business world. But if progress were to result from that law alone, it would be slow indeed and attended by many distressing casualties.

The spirit of progress that is abroad in business to-day uses the "law of co-operation."

The business, the man, the tool, the product that proves a misfit is not destroyed, but is assigned a well-fitting place in the business structure. This is the essential meaning of reorganization.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

Executive Problem 91

REORGANIZING THE EXECUTIVE STAFF

This problem deals with the same situation as does Executive Problem 87. In that problem we studied certain merger plans for three businesses. We found that while these plans were quite different from each other with respect to corporate form, the resulting combination could, under any one of them, be operated as one business.

We shall now consider that the merger has been completed and that the three units are all under one management. It is obvious that a sweeping reorganization of the executive staffs is desirable; it is, in fact, essential if the new organization is to operate efficiently. The reorganization will be the more drastic since it is quite clear that the sales management should be under one head; and so also with office work and with manufacturing, for the Arnold patent and the Northampton cases will be used in all the refrigeration outfits produced by the organization.

(In this respect the merger we are considering differs from many. It is often desirable to continue separate plants and selling organizations for each of the units that enter into a merger.)

Before you can do any planning with regard to methods of reorganization, a survey of the present staffs is necessary. This is what we find. The policies of the Lakota Refrigeration Company are in the hands of Mr. Langhorn, age 52, its president and general manager; Mr. Rall, age 40, vice president and treasurer, who has charge of the office accounting and financing; and Mr. Cox, age 61, its secretary, who is also acting as purchasing agent. Mr. Cox, who has practically retired, averages only a few hours a day in his office. He is "a wise old boy" as his associates are fond of saying. His practical

common sense, his keen insight, and his life-time experience in the refrigeration business are well known; his counsel is often sought by the men in his own firm and by others as well.

Other members of the executive family are Mr. Berger, the shop superintendent, age 34, a technically trained engineer, who is in charge of designing improvements in the refrigeration outfit as well as of the shop operations; and Mr. Chester, the sales manager, who has been striving, and successfully, to maintain the sales force at the point of efficiency it had when Mr. Bushman left. Chester had been Bushman's right-hand man. Before the latter left he had had full charge in all the sales promotion work. As a matter of fact, he enjoyed that type of work more than he did the management of the salesmen. His associates sometimes felt that, as a result, he spent too much time in the office.

A. E. Smith, the latest recruit to the executive family, is traffic manager. He rose to that position by dint of his own efforts by pointing out economies in freight handling. As a result, he has been given charge of all the company's traffic problems.

The Economy Refrigeration Service has a more modest executive staff. Mr. Bushman, age 51, is at its head. He is general manager, sales manager, office manager, and acting treasurer. Mr. O'Brien is treasurer in name, but is in the habit of turning over to Mr. Bushman a number of signed checks which Bushman countersigns as they are issued. O'Brien is not active in the management.

Mr. Arnold, the inventor of the very efficient refrigeration unit that this company sells, is a technically trained engineer who has had years of experience in this business. The responsibility for producing the units has been put on his shoulders. Since the company has no plant except an assembly and shipping room, a great deal of his time is spent out of town, supervising the manufacture of various parts by the manufacturers who have contracted to make them.

Either Bushman or Arnold has to be at the home office, and, since Arnold feels that it is necessary for him to be often away, Bushman is compelled to stay in more than he likes. Notwithstanding this handicap, however, he has built up a sales force which is capable of selling more outfits than they can turn out. A general foreman, Ed Burmer, is in direct charge of all the assembling, inspecting, finishing, crating, and shipping. He is a very competent man. This work has never suffered because of Mr. Arnold's long absences from Lakota.

The Northampton Ice Box Company is a one-man concern, so far as executive control is concerned. Mr. Harris, age 48, is president and general manager. He personally handles all the purchasing. He is in charge of the office and also of the sales and the shop.

John Perkins, the treasurer of the company, is a capitalist; he insists on signing all checks, but almost never comes down to the office. He receives a nominal salary.

The company's designer, Alex MacKnott, is an unusually good man. He gives his spare time as well as his working hours to the study of insulation problems and to the design of the mechanical details of refrigerator cases. He has the rather unusual combination of mechanical genius and an artistic sense which guides him in designing attractive refrigerator exteriors. As an executive, however, he is an almost complete failure. Nominally he has charge of the Northampton shop but actually a competent general foreman supervises its work.

As a practical executive, this foreman, John Siszo, is excellent. He knows nothing, however, about the refinements necessary for low-cost production, and the company has no cost system of any really practical sort.

The sales manager, Robt. Milam, is such in name rather than in fact. He is out on the road most of the time working with various trade outlets that he has established. The company has two other salesmen, but these work under Mr. Harris rather than under Milam.

This in broad outline is the executive force on which the reorganizer will depend for material out of which to build a well co-ordinated, highly efficient operating organization for the new combination. The working paper will suggest to what extent you can proceed, with the information which you have, in working out this reorganization problem.

BUSINESS MANAGEMENT

PROCEDURE IN REOR- GANIZATION [II]—Being Exec- utive Manual 92, on Organization and Reorganization, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
staffs of LaSalle Extension University*

Especially acknowledging the advice and co-operation, in
the various Organization and Reorganization manuals, of

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PROCEDURE IN REORGANIZATION [II]

Part I

FINANCIAL REORGANIZATION

WE SAW, in Executive Manual 91, how the internal operating organization must, in many cases, be changed in order to increase operating efficiency or to meet some new situation which confronts the business. Likewise, it may be necessary to change the financial structure of a business, thru reorganization, in order to provide adequate financing, or more efficient administrative control, or to accomplish any one or more ends hereafter set forth.

What Is Financial Reorganization? While it is true that the legal definition of reorganization is "legal reconstruction of a business after failure," we shall consider reorganization not only as a reconstructive measure, but also in its more constructive application as a means to increase profit. To establish clearly the primary meaning of the word reorganization as used in this manual, let us look upon it in the light of the following definition:

Financial reorganization consists in working out and putting into practice a new financial plan which replaces an old financial plan, found faulty or unsuited to the present state of a business.

If properly worked out, a financial reorganization should enable the company to increase profits, to overcome present financial difficulties, or to put a business on a firm financial footing following a period of insolvency.

The Objectives of Financial Reorganization. Owing to a general similarity in the financial structures of most businesses, we can profitably consider, in a definite way, some of the more common objectives of financial reorganization. A study made over a period of years indicates the following objectives, given in the order of their frequency

of occurrence as ends to be gained in financial reorganization:

1. To reduce fixed charges.
2. To increase the capitalization.
3. To eliminate or correct a faulty financial structure.
4. To pay outstanding, matured security issues.
5. To eliminate unprofitable parts of the business.
6. To diversify the ownership interests.
7. To satisfy holders of cumulative preferred stock on which dividends have been unpaid.

Reducing Fixed Charges. One of the very common objectives of financial reorganization is that of reducing fixed charges. The tendency in many companies which have had to undergo financial reorganization was to allow their fixed charges of various kinds to grow beyond their ability to pay them out of current earnings during periods of business reaction.

Unwieldy fixed charges are often the result of unwise borrowing for the purpose of expanding operations during a prosperous period when the current earnings of the company were well able to take care of them. Then inability to pay them later on forces a more or less drastic rearrangement of the financial organization of the company, to provide funds either for paying the fixed charges or for reducing the long-term debt.

Increasing the Capitalization. In the section of this training service on financing a business, we analyzed the problem of financing a business on borrowed money—when and how to borrow; we also learned that there is grave danger of depending too much on borrowed money and not enough on owned capital. A business concern may want to put thru an expansion program which necessitates increased capitalization, and its financial structure as organized will not permit it. A financial reorganization is necessary to create a financial structure which will permit an increase in capitalization so that the ex-

pansion program can be started with assurance of sufficient funds to carry it out successfully.

Correcting a Faulty Financial Structure. Correction of a growing weak spot in the financial structure of a business often necessitates reorganization. Changes in the financial structure may be made necessary by changing conditions or circumstances within the organization itself. If, for instance, a concern depends largely on short-time borrowing, a period of financial depression may dry up its regular sources of funds, thus making a financial reorganization necessary in order to handle the financing of the business thru the use of more owned capital.

Re-funding Operations. Another common objective of financial reorganization is to pay off an issue of bonds or notes that has matured or is about to mature. It is sometimes very inconvenient or even impossible to take the necessary cash out of a business to pay off a maturing bond issue. Some reorganization of the financial structure of the business may be necessary in order to provide in a satisfactory way for a re-funding issue of bonds or other securities, the proceeds from the sale of this issue being used to pay off the maturing bond issue.

Eliminating Unprofitable Parts of a Business. Where unprofitable parts of a business are to be eliminated, changes involved are often so important that the situation calls for financial reorganization. Certain properties may have to be disposed of, or transferred to a new organization. If these properties are the whole or partial support for an issue of securities, it is obvious that the retirement of these securities must be a step preliminary to the sale of the properties. This retirement of securities may cause a strain on the financial structure which can only be relieved by reorganization.

An instance of reorganization made necessary by the elimination of unprofitable parts of the business is furnished by the history of a large implement company.

This company had gradually taken on a number of manufacturing lines in addition to implement manufacture. The depression following the post-War boom made it advisable to divorce these other lines from the implement business. The properties involved were so large as to necessitate the formation of new companies to take them over. This wholesale transfer could only be accomplished thru complete financial reorganization of the original company.

Diversifying the Ownership Interests. This objective of financial reorganization properly has two phases, one of which was discussed in connection with operating reorganization. The first phase has to do with the death of the principal officer and stockholder in the corporation, in which event it is not unusual for the heirs to want the estate divided up and its holdings diversified. The second phase concerns the reorganization of a business which has been closely held within a family or within a small group of stockholders—where the stockholders wish to withdraw a good proportion of the accumulated worth of the business and reinvest the accumulation in more diversified form.

To carry out either phase of this objective, it is usually necessary to effect a change in the financial structure whereby the ownership interests in the business can be sold to new investors. This change is most commonly made by the organization of a new corporation to take over the assets of the old, the division of the capital stock of the new company into several times the number of shares in the old, and the sale by the stockholders of the old company—who acquire the stock in the new—of a good proportion or all of their holdings to a firm of investment bankers.

You will remember that a similar procedure was worked out by the owners of the Hall & Foster Brothers Mail Order House (Executive Problem 73) in disposing

of the holdings of one partner and in attracting new capital. This case also illustrates a not uncommon feature of financial reorganization for the purpose of diversifying the ownership interests. The firm was actually worth much more than its financial statement disclosed—a condition often obtaining with partnerships and close corporations. Consequently, the ownership interests were not readily salable in their then form, and a financial reorganization was necessary.

This matter of diversifying the ownership interests is of especial importance where it is desired to attract more capital by making the ownership interests readily salable in the public market. This is why so many companies, reorganized for the purpose of attaining this objective, have gone a step further and listed their shares on the stock exchange. They were not only meeting present needs, but also providing for expansion. They were following this principle:

Creating a present active market for the shares of a company aids in carrying out future financial plans which call for the raising of outside capital.

When the firm of investment bankers that purchased the Dodge Brothers Company listed the company's shares on the New York Stock Exchange, it had in mind more than promoting the sale of the shares then outstanding. It was providing also for future stock offerings.

Satisfying Preferred Stockholders. We saw in our discussion of cumulative preferred stock in a previous manual that holders of cumulative preferred stock have prior claim on the earnings of a corporation until the indicated dividends are paid. When the dividends are allowed to accumulate over a period of time thru the inability of the company to pay them, the holders of the common stock are placed at a great disadvantage. They cannot expect a return on their investment until the preferred dividends are paid. The resulting dissatisfaction among the common stockholders, therefore, as well as among the

preferred stockholders, sometimes leads to a financial reorganization of the company, whereby the claims of both common and preferred stockholders can be adjusted equitably by the issue of new securities.

Now that we have in mind a broad outline of some of the more common objectives or causes of financial reorganization, let us examine the unavoidable conflict of interests among holders of various securities, which makes the work of the financial reorganizer difficult.

The Conflicting Interests of Security-Holders. Executive Manual 89 brought out the fact that security-holders may be divided roughly into two classes—

1. Those who have a creditor's relation or interest in the business.
2. Those who have a proprietary interest.

In a reorganization there is a conflict between the interests of these two groups. Each holder of securities is naturally in favor of that reorganization plan which will, so far as possible, set the highest value on his holding and promise the continuance or appreciation of that value.

In a reorganization which has as its object the reduction of fixed charges, the bondholders are naturally disinclined to accept a reduction in their interest rate; on the other hand, the stockholders will do all they can to persuade the bondholders to accept a reduction in interest or principal, and leave the common stockholders untouched by the reorganization plan.

The section on financing a business explained how some securities have a priority of claim on the assets of a business over other securities. Broadly speaking—

In a forced reorganization those securities which have a prior claim on the assets of a business exercise a preponderance of power.

In a reorganization which is *voluntarily* undertaken by a solvent company, to make more profitable operation possible or to simplify the financial structure, the deci-

sion as to its plan or form of reorganization usually rests with the stockholders. In a *forced* reorganization, caused by failure or financial distress, those who have a creditor's claim (such as bondholders and noteholders) have the preponderance of power—the whip-hand, so to speak.

While the stockholders in a forced reorganization have little to say about the policies to be adopted in the reorganization, it is not to be inferred that they can be ridden over roughshod by the bondholders, because, if there is any cash required by the reorganized company, the stockholders are expected to supply at least some of it. We will see later on how the stockholders' interests must receive equitable consideration by the dominant party in a reorganization.

The Part Played by the Officers and Directors. In a voluntary financial reorganization, the directors and officers of the company play an important part. They formulate a reorganization plan and submit it to the interested parties; but, in a reorganization forced thru failure, they play at best only a passive part. The fact that the business has failed while under the guidance of a certain board of directors and officers indicates, as a rule, inefficient management on their part. There is a presumption that they are not best qualified to handle the reorganization, altho they may contribute important services which help greatly in developing a successful plan of reorganization.

We shall see thruout our discussion of forced reorganization that a certain amount of compromise between the conflicting interests is necessary; that in attempting the rehabilitation of an unsuccessful business, all the parties concerned must lay aside personal prejudice and self-interest and concentrate on an equitable method of putting the business on its feet. They cannot afford to tolerate any unreasonable insistence on personal or group prerogatives.

The Use of Committees in Financial Reorganization. The stockholders, the general creditors, the bondholders, and the holders of other corporate securities of a large corporation are often too many in number and too widely separated to be able to assert any sort of unanimity of opinion. As a result the various groups of creditors and security-holders are each, as a rule, represented during the reorganization, by committees. In a voluntary financial reorganization, these committees consider the reorganization plan submitted by the management or by bankers and make their recommendations to the groups they represent. The security-holders and creditors, having final voice in the matter, accept or reject the proposals of their committees.

In an involuntary reorganization brought about by failure, we often find extreme confusion in the formation of committees. Inasmuch as these committees spring out of the ground, so to speak, it is often the case that there may be two or more committees, each with a different plan, purporting to represent the same class of securities or claims. Ordinarily there is an eager rush for the seats on a reorganization committee, for as a rule some attractive emoluments accrue to the holders of these positions, particularly if the reorganization is a large one.

Committees representing holders of securities in a business that undergoes reorganization are elected or appointed if the reorganization is voluntary; but they are largely self-organized if the reorganization is involuntary.

The general creditors, a class that usually includes one or more banks, usually have little difficulty in organizing to protect their claims, for, as we have seen in Executive Manual 55, their credit departments are experienced in such matters. They have learned the advantage of united action and usually agree on some one of their representatives to handle the claims of all.

In the event that there are two or more committees claiming to represent the holders of any one type of secur-

ity, little that is constructive can be accomplished until there is an expression showing what the majority in this group of security-holders want to do. The recognition of this fact precipitates a struggle between the conflicting committees to secure a majority of proxies from the holders of this type of securities. The natural skepticism of the security-holders must be overcome and at least some semblance of unanimity of opinion obtained before it can be truly stated that a committee really represents the holders of a particular class of securities.

The Reorganization Committee. As soon as the holders of each security are represented by a committee, the real struggle for control of the general reorganization committee starts. In a forced reorganization, the various committees start negotiating with one another and with the receiver to get the most favorable conditions for the securities they represent. In the series of compromises incident to this negotiation it is usual to have some one of outstanding personality act as arbitrator between the various committees. Sometimes this outstanding man is the receiver, sometimes a representative of a banking house; in any event—

It is imperative that some dominant man take a leading role in judging the validity of the various claims and in selecting the final reorganization committee.

As a general practice the reorganization committee, which is made up of representatives of the various committees of security-holders and of the creditors, is the body which formulates and decides on the final reorganization plan.

To be sure, there may be many discontented minority interests who will attempt to obstruct the committee's plans, but ordinarily the final reorganization committee is not formed until there is assurance that a working majority of proxies is represented.

In the event that minority interests believe that the majority interests are attempting to crowd them out and

force thru plans which will deprive them of their rights, there is always an opportunity for the minority interests to appeal to the courts for relief from this alleged oppression.

The First Steps in a Forced Reorganization. The first step to be taken by the general reorganization committee or by the individual in charge of reorganization is to determine the exact present financial status of the business. It is obvious that a mere acceptance of the last financial statement of the company which is to be reorganized would be insufficient ground on which to base any reorganization plan. While the determining of the exact financial status may be a lengthy and, possibly, a costly job, this information is of course indispensable.

Cases have sometimes been encountered where the officers of a concern, knowing that their business was approaching bankruptcy, have juggled its accounts in an attempt to gain time, hoping that something would happen to save the business. In such cases, obviously, the books of the concern must be carefully audited and corrected before any real consideration can be given to the problem of reorganization.

A certain holding corporation, with its central office in New York City, failed. The reorganization committee first thought that only the parent company was involved, but closer examination disclosed the fact that the treasurer of the company, located in New York, had discounted a great many notes which were the direct obligations of many of the subsidiary companies. This necessitated the inclusion of those companies in the bankruptcy proceedings.

The following principle should always be followed and will do much to give an accurate basis from which to work out a reorganization plan:

Before any consideration can be given to a reorganization plan, a complete detailed statement must be

prepared, showing the true financial condition of the business at the present moment.

The Individual Reorganizer. In small forced reorganizations, the reorganization plan is usually formulated and carried out by one individual, who, in most cases, is the receiver appointed by the courts to administer the affairs of the company. In large reorganizations, it is usually too difficult for one man to get the needed support to assure that his plans will have the support of a majority of the security-holders, and a reorganization committee is needed.

We saw in our discussion of internal operating reorganization how an active, dominant leader was conducive to effective reorganization work. This is also true in a financial reorganization.

The ideal arrangement is one in which the entire responsibility for effective reorganization is centered in one experienced, forceful, and fair-minded individual.

This individual, can, in turn, delegate some of his responsibility to other individuals so that his plans can be effectively carried out. As pointed out before, the conflict of interests which obtains in a forced reorganization often prevents such centering of responsibility. The nearest approach to an ideal condition which we can hope to obtain in a large reorganization is to have a representative committee with an active, dominant head.

In voluntary reorganization, on the other hand, there is ordinarily no marked conflict of interests, as the benefits to be obtained thru reorganization are usually apparent to all alike. This absence of conflict allows a one-man control of the formulation of the plan and of the administration of the plan's execution. This one-man control, coupled with freedom from contention with conflicting interests, largely accounts for the fact that voluntary reorganizations are usually free from the confusion and bickering which usually characterize forced reorganizations.

The Receiver's Work in a Forced Reorganization. We learned in a previous manual how a receiver is appointed by the courts to administer the affairs of a business which has failed. Much of the success of a reorganization depends on the work of this receiver.

During the negotiations between the committees representing the various security-holders and during the formation of the final reorganization committee, the receiver is supposed to exert every effort to bring the operating organization to a high state of efficiency; for—

Financial reorganization will do little good if the operating organization is faulty or inefficient.

It must be remembered that the receiver is exercising his office under authority of the courts and he cannot, ordinarily, dispose of any of the defunct company's property without court permission; consequently, in the case of obvious incumbrances, the court will usually permit the sale of these assets provided the rights of security-holders whose bonds or other securities give them power to foreclose a mortgage on those assets, are protected.

Considerable latitude is given to the receiver by the courts in the matter of internal operating reorganization. We often find receivers who have the necessary qualifications, putting thru such well-planned internal reorganizations that only minor financial adjustments are required to make the future outlook for the business very good.

The Legal Consideration of Reorganization. Before we consider in the next sections of this manual some actual organization plans in detail, let us get a clear idea of what reorganization means from a legal standpoint.

When the reorganization is voluntary, and no one is raising serious objection to the plan, all that may be needed is that the stockholders agree to increase the capitalization—or to decrease it, each surrendering stock on some agreed basis. Or the bondholders may agree on an

issue of new bonds. As a rule, state authorities will grant an application for any legally and financially sound change in the company's charter.

As we shall see later, it is sometimes desirable to reorganize voluntarily as a new corporation, perhaps under the laws of some other state. In such cases, application for a charter for the new corporation is made in the usual way, and, when all the assets have been transferred to the new company, the charter of the old corporation is usually surrendered and formal dissolution accomplished pursuant to law.

When a business is in financial difficulty, and the parties at interest find it impossible to work out a voluntary reorganization, some one of the creditors or stockholders can ask the state or federal court (whichever has jurisdiction) to appoint a receiver, on the ground that otherwise the assets of the corporation will fall in value, and his interests will be impaired.

The Attitude of the Courts toward Receivership. The courts are reluctant to grant a petition for receivership. They, as a rule, refuse to do so unless suits are already pending against the company, and then only upon clear evidence that a receivership is justified. A receiver is an officer of the court, appointed to hold the properties, to operate the business, to receive all the income, and to conserve all the assets until the difficulties have been straightened out. The receiver may be, and often is, one of the executives of the business. At all events, the courts can be trusted to appoint a man of high executive training and wide experience.

The receiver holds the property of the company for the court, and no one can proceed against it without the consent of the court. This is one of the reasons why receiverships are often necessary in reorganizing a business. They prevent individual creditors from seizing the liquid assets, and they prevent the bondholders from foreclosing

mortgages on which the bonds are based, before plans for reconstruction have been worked out.

A reasonable time is gained to evolve a plan of reconstruction and to "sell" the interested parties on the fairness of this plan. The rights of none are impaired by the receivership, and the urge to get together on a constructive plan is strong on both stockholders and creditors (except those whose claims are amply secured), since the forced-sale prices obtained for the assets at bankruptcy and foreclosure sales are usually far below the value of these assets to a going concern.

The courts are glad to discharge the receiver as soon as the business is again a solvent, going enterprise.

Putting the Plan before Security-Holders. Let us assume that a definite plan has been formulated by a general reorganization committee. The next step, once the plan has been decided upon, is to get acceptance of the plan by the security-holders. This acceptance is usually secured by having the plan, in detail, printed and distributed to the interested parties. Those who accept the plan indorse their securities or claims and forward them to some designated bank or trust company where they are held in trust until the plan is completed.

If the plan has received the almost unanimous support of the security-holders, the court may declare the plan effective and binding even on those security-holders who have not consented to the plan.

If approximately unanimous consent is not obtained, it is usual for the assenting stockholders to form a new corporation with a name similar to that of the old company and to buy the property of the old corporation at a receiver's sale. This is done thru an agreement, which must be sanctioned by the court, by which the new corporation turns over sufficient cash, bonds, and other securities to satisfy the creditors of the old corporation and thus to free it from debt. In other words, the assets of

the old corporation are sold by the receiver for enough to discharge all creditors' claims, and the new corporation comes into possession of these assets. It is usual, in such transactions, for the assenting stockholders to receive shares of stock in the new corporation, virtually in exchange for their shares in the old.

The stockholders who have not turned in their stock are left holding stock in a company that has no liabilities, but no assets either, except for such unsalable items as goodwill. Of course, if the sale price received at the receiver's sale is in excess of liabilities, the nonassenting stockholders are entitled to their share of this excess. It is only where the nonassenting stockholders are bound by the court, or where the proceeds of the sale are sufficient to pay the debts only, that these stockholders get nothing.

After the receiver's sale the reorganization committee is in a position to distribute securities in the new corporation to the owners of the old securities who have met the terms of the reorganization plan, in such proportions and amounts as provided for in the plan.

PROCEDURE IN REORGANIZATION [II]

Part II

FINANCIAL REORGANIZATION PLANS

NOW that we have a general understanding of the problem of financial reorganization, we are ready to take up some reorganization plans in detail, surveying the actual procedure in accomplishing the definite purposes which were analyzed in the first part of this manual. The fundamental procedure outlined in this manual may be readily adapted to the solution of financial reorganization problems wherein conditions vary from those herein considered.

The Value of Competent Legal Counsel. There is one principle in particular which should always be kept in mind in any financial reorganization work:

All steps in a financial reorganization should be taken under the advice of a competent attorney familiar with business organization and business law.

Having such legal counsel will do much toward smoothing the path of the reorganization managers and giving the confidence so necessary in any major undertaking. It will assure the reorganizers that their work will not later be undone by the courts, and that advantage will be taken of the most favorable features of business laws in the various states.

Companies doing business in more than one state often find it to their best interests to reincorporate in a different state where regulatory restrictions are less stringent or where corporation taxes are less onerous. Advantages and disadvantages of incorporating in various states should be carefully weighed; hence, the counsel of an experienced, fully informed corporation lawyer is indispensable.

Frequently the controlling factors are not readily apparent to the reorganizers themselves. In one case, for

instance, the stockholders in a company going thru reorganization were unanimous in their desire to reincorporate in another state; then their counsel pointed out to them that the advantages they would gain thereby would be outweighed by the disadvantage of having to pay taxes on the stock of a foreign corporation. The stockholders were all residents of the state in which the company was then incorporated, and in that state the stocks of domestic corporations were tax free.

A Reorganization Plan to Raise Capital. Almost all concerns which undergo a forced reorganization need more capital. In some cases they need it for repairs and new capital assets, but in most cases a new supply of working capital is needed. And the fact that the company is in the hands of a receiver or of the creditors makes the raising of cash a very difficult matter.

Investors, ordinarily, have many more profitable uses for their capital than to bolster up an insolvent business. This fact makes outside financing very difficult if not impossible, and necessitates sacrifices and contributions on the part of the security-holders or creditors, or both. There are four general ways in which capital can be raised or a reduction in outstanding liabilities can be secured, as follows:

1. Issuing new securities which have exceptionally well secured claims on the assets of the company and which are issued on particularly favorable terms.
2. Levying an assessment on the stockholders or, at times, on the bondholders.
3. Convincing creditors of the advisability of accepting securities of some sort in payment for the whole or part of their claims.
4. Borrowing money on notes indorsed by responsible individuals.

A West-coast novelty manufacturing company was recently in financial difficulties. When the company was started, the organizers had been unable to sell enough stock to provide the business with adequate operating

capital. The cost of the plant and machinery was close to \$75,000. Fifty thousand dollars of this amount had been paid out of the proceeds from the sale of capital stock and the remaining \$25,000 had been raised by corporation notes indorsed by some of the larger shareholders. The money realized from the sale of additional stock did little more than pay the organizing expenses and left a very small amount of working capital, so the company was almost constantly in hot water with its creditors.

The corporation notes were approaching maturity and there was little hope of the corporation getting enough money to meet them, altho net profits had been slowly increasing and dividends had been paid regularly. The basic troubles with this company were a too low capitalization and the declaration of dividends which really should have been plowed back into the business to reduce the current obligations.

The reorganization plan called for the issue of \$10,000 worth of long-term corporate notes bearing 7 per cent interest, and the issuance of \$30,000 worth of 8 per cent cumulative preferred stock. The preferential features of these two obligations, coupled with the steady earnings in the past, made these securities fairly easy to sell.

Naturally, the common stockholders could not expect any dividends for some time, as the net profits of the company would be utilized in paying interest on the notes and dividends on the preferred stock and in building up a reserve to retire the notes at maturity. The stockholders realized, however, that after the notes had been retired they would have an exceedingly valuable property entirely free from encumbrances.

Assessments on Security-Holders. The present tendency, in forced reorganizations, is to obtain fresh cash capital, in part, at least, from the present security-holders. Outstanding issues of securities may be scaled down and new issues created, which the holders of present securities may

be required to buy in order to retain their equity in their scaled-down holdings.

Thus the reorganization plan of one company required the holders of its common stock to surrender one-half of their stock and to subscribe for part of an issue of new preferred stock. It required the holders of the old preferred stock to exchange one-half of their shares for a like number of shares of common stock, and to purchase two shares of new prior-preference stock for each ten shares of preferred formerly held. The company paid its bondholders part in cash, part in new secured notes, and part in new prior-preference stock. It paid its unsecured creditors in new prior-preference stock.

In conjunction with the levying of special assessments on security-holders, new security issues may be used to attract new outside capital. Of course no attractive securities can be issued if there is not tangible, unincumbered property or assets to serve as a basis for refinancing. When the assets of a corporation are already pledged to the limit, it is not uncommon to resort to direct assessments to raise needed cash. Direct assessments may also be used for the purpose of clearing up a small but troublesome incumbrance on the fixed assets.

Naturally, stockholders and junior bondholders resist any attempt to levy an assessment on the securities they hold, but we rarely encounter a forced reorganization in which the stockholders, at least, are not called upon to make some sort of financial sacrifice.

Ordinarily an assessment is levied on those security-holders whose claims would be paid last in case of dissolution.

The general acceptance of this principle inclines reorganization committees to make any assessments in the following order: first the common stockholders, then the preferred stockholders, and finally the holders of junior bond issues.

No matter how strongly the holders of these securities

may object to assessments, they usually come to the realization that, if they are to conserve as much of their original investment as possible, they must be willing to make a further contribution. They cannot be compelled to pay the assessed amount but, if they refuse to do so, they are likely to get nothing out of their equities when the business is sold under court order. The discontented security-holders will then be left out in the cold, so to speak, unless they can raise enough money to take over the business themselves. This fact usually serves to bring the assessed security-holders in line and to convince them that their future interests will be best served by paying the assessment.

It is fairly common practice to issue to the security-holders some sort of stock or other security of the reorganized corporation in return for their cash assessment. Of course, the value of these new securities is entirely dependent on the stability of the new company, but the assessed security-holders have something to show for what they have put in.

In one large reorganization, a cash assessment of \$10 a share was made on the common stock. The stockholders then received new common stock for their old stock and, in addition, ten-year debenture bonds equal in par value to their cash assessment. This was done in recognition of the principle that—

A reorganization committee should realize that security-holders will more readily pay assessments levied on them if they are given certain inducements that will compensate them, in a measure, for the cash sacrifice made.

Paying Creditors with Securities. Ordinarily it is difficult to induce creditors to accept company securities in payment for their claims except in cases where a merely temporary cash shortage exists. A creditor company naturally expects to be paid in cash for goods or services rendered, and its own financial budget is based on that

anticipation. Its own financing may be seriously handicapped if it is not able to realize cash on a large account within a reasonable time. The objection to the acceptance of securities in lieu of cash is the fact that the securities of a financially embarrassed customer rarely have a ready market. Such securities can seldom be sold for cash, and it is often impractical to use them as collateral for a bank loan, even where they are secured by a mortgage on valuable assets. The reason for this is that the assets would shrink greatly in value were they put up for forced sale, since they derive much of their worth thru their use in a going business.

The creditors' attitude toward the acceptance of the securities of a company which is in straitened circumstances is largely governed by the amount of realizable assets the company owns.

If the forced-sale value of the debtor's assets is large and if the cash left over, after paying prior claims, promises to be large enough to satisfy the creditors, there is little hope that the creditors can be induced to accept securities in lieu of cash. But if the forced-sale value of the assets is too small or if it is likely to be swallowed up by prior claims, the creditors will usually make the best of it by accepting securities.

It should not be inferred that all creditors take a cold-blooded stand on this question of accepting securities. There is a growing tendency among creditors to co-operate with the management or reorganization committee as much as they can, for they are coming to realize more and more the interdependence of business concerns—especially the interdependence of suppliers and customers.

Reducing Fixed Charges. A great many reorganizations are caused by the fact that a concern has contracted such high fixed charges that its net operating income is not enough to take care of them. These fixed charges are accumulated in many ways, primarily by too much borrowing. If high fixed charges is one of the causes of

financial difficulty, nothing much can be expected of a reorganization which does not reduce them materially.

Certain railroads and other businesses requiring large outlays for construction work have piled up fixed charges to such a degree that, when these charges could no longer be paid, reorganization has been the only solution. We have a good example of this type of reorganization in the case of a large railroad which had borrowed so much for construction purposes that its net earnings were less than one-half of one per cent of its funded debt. With a poor outlook as to earnings, a reorganization was undergone whereby all outstanding bonds were replaced by new preferred and common stock, and the old common stock replaced by a new issue.

The senior bondholders received preferred stock equal to the par value of their old securities. The junior bondholders received some preferred stock and some of the new common stock. They were also made to pay a small cash assessment for which they received new first-mortgage bonds. The common stockholders were given one share of new common stock for each two shares of the old, and were required to make cash purchases of an amount of preferred stock in a certain proportion to their common-stock holdings.

This handling of the bondholders was, of course, very drastic, but was the most feasible way by which their equity in the property could be ultimately conserved.

The new issue of bonds formed only a small portion of the capitalization of the reorganized company, so that the old bondholders could expect first claim on the future earnings after the low interest charges on the new bonds had been met.

The Essentials of Reducing Fixed Charges. A prominent railroad reorganizer has stated that five essential points should be remembered in a reorganization which has as its object the reduction of fixed charges:

1. The fixed charges after reorganization should be less than the probable minimum of net earnings.
2. As large a proportion as possible of the fixed charges should consist of interest on bonds; guaranteed dividends and rentals should be avoided as far as possible.
3. The losses should fall most heavily on the junior security-holders; leaving first-lien securities as free from sacrifice as possible.
4. While the fixed charges should be cut, the nominal value of new securities received by the security-holders in exchange for their old securities should be reduced as little as possible.
5. Bondholders whose claims are scaled down should be given a compensating chance to participate in future increases of earnings.

Any reorganization having as its object the reduction of fixed charges will only be a temporary expedient, and of no permanent benefit, unless the first essential, as given above, is adequately provided for.

This, of course, is obvious, since the very purpose of the financial reorganization in this instance is to make certain that fixed charges can be paid. Nothing but the most conservative estimate of minimum net earnings should be taken as a basis for calculations, for fixed charges have to be met in bad years as well as good.

Concentration of Fixed Charges. Where fixed charges other than taxes and depreciation cannot be eliminated in the reorganization plan, it is wise to concentrate most of these fixed charges in one group of securities. This group will, preferably, have a mortgage interest rather than a proprietary interest.

For one thing, the capital structure of the rehabilitated company will be freer of complications. Second, the fixed interest charge on an obligation secured by a mortgage is usually lower than on a debt not so secured. Third, the management will have a freer hand in carrying out its policies, since the security-holders will be creditors rather than part owners.

Allocating the Losses. The third essential—that the losses should fall most heavily on the junior security-holders—is carrying out the principle we have already given: that the priority of lien should be a safeguard against the demand for financial sacrifices.

In reorganizations where mortgaged property has a forced-sale value exceeding the amount of first-mortgage bonds, the equities of the holders of these bonds are almost always left undisturbed.

The fourth and fifth essentials should be included in the reorganization plan so as to offer some inducement to restrain security-holders from putting up resistance to the reorganization plans. As we have pointed out before, this usual conflict of interests is costly and may delay reorganization so long that rehabilitation of the company will be impossible.

Effect on Capitalization. Care needs to be exercised, however, in creating new securities to be issued to old stockholders and junior bondholders. Where the nominal value of new securities exchanged for old is not materially reduced, the result is usually to increase the net capitalization of the reorganized company. This result may not be at all desirable. In fact, it may seriously hamper the ultimate recovery of the company.

Many of the early railroad reorganizations suffered in this respect. One writer describes their experiences and says:

The reason was that in order to induce the holders of junior bonds and stock to undergo sacrifices, they must be placated by liberal bonuses of well-nigh worthless junior securities of the new road.

The tendency since 1910 has been to so plan reorganizations as to effect a reduction rather than an increase of the net capitalization. Especially is this true if the old floating debt, which is funded by the reorganization, is included in the computation.

The temptation to issue excessive amounts of junior securities no longer exerts a malign influence. Stockholders show a more intelligent discrimination between nominal and real value.

Advantages of Increased Capitalization. It is customary

in reorganizations, however, to issue stock or other securities to those who have been called upon to make cash contributions or who have converted their claims, either secured or unsecured. As a result of this practice, corporations often have an increased capitalization after going thru a forced financial reorganization. This may be a disadvantage to the junior security-holders but from the company's standpoint, the fact that many of its obligations to creditors have been converted into a mere participating interest in the assets and earnings, makes an increase in capitalization carry with it distinct advantages.

If a creditor interest in a corporation can be converted into an ownership interest, the financial operation of the corporation is very much facilitated.

Where bonded indebtedness can be entirely eliminated, the management can devote the entire net income to the strengthening of the company's assets and to the payment of dividends, there being no interest or sinking-fund charges to be met. In such a case, the elimination of fixed indebtedness nearly always results in an increased capitalization, yet the effects of freer managerial control are likely to be very favorable to the ultimate appreciation in value of the equities of the original owners.

Reorganization usually simplifies the financial structure of the business. At least, that should be one of the aims. A large corporation which feels that failure is impending, usually incurs many kinds of obligations in an attempt to raise cash to forestall failure. When the reorganization committee formulates its plan, it usually provides for clearing out this financial underbrush by substituting some long-term bond issue or new stock issue—frequently both. The result may be an increase in the net capitalization, but the financial structure is simplified and re-established on a sound basis.

Eliminating Unprofitable Branches thru Reorganization.
A financial reorganization furnishes an excellent oppor-

tunity to eliminate any unprofitable branches of the business. Of course, if the unprofitable branch or plant were free from encumbrances, the supposition is that it would have been sold as soon as the management found that it was unprofitable. We frequently find, however, that when a company gets into difficulty it mortgages all its property up to the limit in the effort to raise needed cash. Thus, it is rarely the case that any part of the business is entirely free from encumbrances.

When an insolvent company is undergoing reorganization, any unprofitable branches should be eliminated.

If the unprofitable property is the basis of a separate issue of bonds, the holders of these bonds are often told that they can foreclose on the property and do what they please with it.

When the bondholders realize that they have the prospects of owning a property for which they have no use and which they cannot sell for the full face value of their holdings, they are usually willing to come to terms with the reorganization committee of the insolvent corporation. In many cases the sacrifices they are willing to make will, thru reduction of fixed charges, enable the previously unprofitable branch to be operated at a profit in the future.

This method of dealing with the security-holders of unprofitable branches may seem cold-blooded; but the fact is that financial reorganizations are usually cold-blooded. The formulating of a financial reorganization plan cannot be entrusted to a man who tries to avoid hurting the feelings of the various claimants. The exigencies of the situation must be courageously faced, and a plan adopted that will conserve as much as possible the equities of all the interested parties.

Nominal Reorganizations. We saw, in our discussion of incorporation, how the laws of some states offer more freedom of corporate activity than others. This fact is

sometimes the cause of a nominal reorganization, inasmuch as a corporation sometimes finds its activities hampered by taxation or regulatory restrictions of the state in which it is incorporated. If it is possible to find a state giving the freedom of action desired, the company may be reincorporated in that state, and all the assets and liabilities transferred to the new organization. Of course, any step leading toward this end should be undertaken only after due consideration has been given to all the advantages and disadvantages of the proposed move.

In these cases of shifting the state of incorporation, it is usual to make little, if any, change in the financial structure, merely exchanging the securities in the old corporation for similar securities in the new.

A nominal reorganization is sometimes undergone as a step preliminary to a consolidation, the idea being that the capitalization of one of the companies should be expanded or contracted to make the value of one of its shares equal to the value of one of the shares of the other company. Then it is possible simply to exchange shares in the consolidated company for shares in the merged companies. Such an arrangement to facilitate the exchange of shares is usually conducive to the acceptance of the consolidation plan by the stockholders interested in the merger.

Reorganization for Shifting Corporate Control. We saw in a previous manual how the corporation is often developed from the proprietorship or partnership. When these changes of organic form take place, the control of the corporation is usually centered in one or a very few individuals. In the case of a proprietorship converted into a corporation, the old proprietor serves as president or chairman of the board and holds a majority of the voting stock. His holdings are nearly always made up entirely of common stock because common stock is usually the sole or principal voting stock, and because its dividends are not limited as in the case of most preferred stocks.

When the man in control dies, it is quite natural for him to leave his stock holdings to his family. Where no member of the family is qualified or willing to assume the responsibility of active management, it becomes necessary to delegate this responsibility to some one else who may have little or no ownership interest in the business. And as we have pointed out before, management is most efficient when it shares adequately in the earnings of the business. It is also a principle that—

It is well to have the active management correspond to ownership control as closely as possible.

This ideal condition can be brought about, in the case of family control, by reorganizing the company so that the common stock held by the family can be partially converted into a preferred issue carrying protective features as to the conservation of assets and earnings. New common stock can then be created, part of which can be made available to executives and employees. Such an arrangement accomplishes a two-fold purpose. It fosters adequate, protected returns to the family of the former majority stockholder on their investment, and it offers the executives and employees the stimulus of an ownership interest in the business.

A Typical Reorganization Plan. Let us examine the experience of another company which recently went thru a typical reorganization. We will thus be able to study the technical procedure and analyze the various details which were considered in the formulation of the final reorganization plan.

The A Marketing Corporation was organized in 1923 by a group of fruit growers, to market their products. The object of the corporation was to afford a connecting link between the fruit growers and the dealers, and thus eliminate the jobber control over the fruit producers. The organizers felt that the idea was basically sound and they succeeded in selling the capital stock of \$800,000 to interested growers. Most of the first year was spent in

establishing branches and dealer connections and in erecting local packing plants and a box factory.

The fruit season found the marketing corporation with the mechanism of the organization ready, but with a cash working capital of only \$200,000 on hand. The plant and equipment investment was approximately \$500,000 and the other \$100,000 of the capital had been expended in organizing the corporation, in market surveys, and in the establishment of sales branches. The crops which the corporation had contracted for had a value of about \$1,200,000, and the fruit was now beginning to arrive at the packing plants.

The corporation had to make heavy cash expenditures to pack the fruit and to pay for the box shooks, so it was forced to give its short-term notes in payment for the fruit delivered by the growers. This led to a storm of protest on the part of the growers, who had expected cash for their deliveries. In order to meet their current expenses, most of the growers discounted the company's notes at their local banks.

The receipts from the company's sales of the fruit were hardly up to expectations, owing to the newness of the sales organization. After losses caused by spoilage were deducted, it was found that the corporation had only enough income to pay its outstanding obligations and to meet its operating expenses. In other words, it was in practically the same financial position as it was when it started operations. At the end of the first year there were no profits from which dividends could be declared.

The stockholders, who were also the growers, gave up hope of any profit and, were it not for the fact that they had money invested in the stock of the corporation, would have contracted to sell their next year's crop to the old jobbers. After a stormy stockholders' meeting, the stockholders demanded a reorganization. In fact, they refused to sign the next year's crop contracts until a satisfactory reorganization had been worked out.

The Report of the Reorganization Committee. A reorganization committee was formed. It investigated the affairs of the corporation thoroly and brought in a report. This report indicated that the basic trouble with the corporation was not lack of efficiency but rather the short period of seasonal operations, which would not yield a fair profit in view of the large investment in buildings and equipment. The committee pointed to the large wastage in last year's crop and showed how, if the waste had been eliminated, satisfactory dividends could have been paid. It proposed the following plan:

1. That a 7 per cent mortgage bond issue of \$300,000 be authorized, to be secured by the plant and equipment already paid for.
2. That an issue of \$300,000 of 7 per cent nonvoting preferred stock be authorized and offered to the banks in part payment for the corporation's notes which they had discounted, the remainder to be paid in cash.
3. That cannery equipment be purchased and installed in the packing plant, thus cutting down wastage and permitting a longer period of sales activity.
4. That, owing to the high cost of maintaining branches and the essentially seasonal nature of the sales activities, the branches be discontinued and the trade covered by traveling salesmen working out of the home office.
5. That sales contracts be made in advance of actual crop deliveries instead of waiting until crops became available.

Here is a combination of financial and operating reorganization. The mere raising of funds would not have helped the situation unless the operating changes were adopted, and the new operating plans could not be carried out unless the corporation was refinanced.

The first step to be taken in the above reorganization was to prepare the plan in detail and to present it to the stockholders for acceptance. When the future benefits of this plan had been pointed out, the stockholders were glad to accept it. Then the banks were persuaded to accept the nonvoting preferred stock in part payment for the notes they held. With these obligations out of the

way, the company could proceed to create a mortgage on its property and to issue bonds against it. With the capital raised thru the sale of these bonds, the necessary canning machinery was purchased and the operating procedure put into effect.

As a result of this reorganization, the first year of operating under the new plan enabled the corporation to make a net profit of 10 per cent after paying fixed charges and dividends on the preferred stock. To-day the company is flourishing and occupies an enviable position in the fruit industry.

PROCEDURE IN REORGANIZATION [II]

Part III

PREVENTING FINANCIAL FAILURE

WE NOW come directly to another brief study of financial failure: its causes; its symptoms; and its prevention, primarily thru financial reorganization, remembering that—

Since financial reorganization is primarily a constructive function, it should be used to anticipate difficulties as far in advance as possible.

Failure may come unexpectedly, but its cause is more than a temporary adverse condition. One business man who has made a special study of business failures, sums up the case in this paragraph:

Many a man becomes so absorbed in running his business, in increasing sales, in cutting expenses, and in trying to build for the future, that he loses perspective, his viewpoint becomes distorted, and, as a result, the whole structure of his business is weakened. This weakening process may—and usually does—continue over a long period without anyone being aware of it. Then a temporary condition, such as a depression, slump, or the like, comes along and finds the business without sufficient reserve strength with which to combat it. And the business goes to smash—killed, not by the temporary condition, but by the weakening effects of unseen causes that preceded the temporary conditions.

A General Cause of Business Failures. In studying the causes of financial failure we shall want to bear in mind this important fact:

Financial failure is primarily the result, not of a sudden happening, but of the culmination of events that have weakened the business over a period of time.

A business goes thru various stages of financial weakening and distress before it becomes totally insolvent. Curative measures can best be taken during the early stages of the trouble, just as the blasting effects of physical disease

can best be prevented before acute distress becomes pronounced. Financial reorganization is comparable to a surgical operation—to be undertaken only if absolutely necessary, but when found necessary, to be undertaken as soon as possible.

This is in line with the viewpoint that financial reorganization should be constructive. It does not mean that financial embarrassment can be cured only by reorganization. A business may develop a weakness in balancing its income and outgo of funds; for example, it may put too much money into slow-turn inventories. In such cases, there are always temptations to make use of temporary makeshifts—"anything to tide us over for a time." But an embarrassment of this kind can rather easily be cured once the cause is recognized, while makeshifts too often lead to acute financial distress, and even to financial insolvency, before the management decides to take proper curative measures.

If management is properly guided by sound business principles, it will ever be on the alert for symptoms of trouble.

It will provide ways for correcting financial embarrassment before the stages of distress and insolvency are reached. That is why, in our study of the causes of failure, we should endeavor to go beneath surface indications and find the true underlying causes.

Underlying Causes of Failure. An analysis of the many failures occurring yearly in business enables the executive to know why failures occur and makes it possible to guard against similar causes in his own business. Of course there are some causes of failure such as earthquakes, wars, and governmental acts, which can only be prevented by adequate insurance or by the exercise of keen foresight. What we shall first be concerned with here are preventable causes, causes intimately connected with the business itself. Your study of these factors will enable you to use your knowledge of economics and business management

to avoid the financial failures which these causes bring to those unprepared to cope with them.

We touched on the causes of failures in Executive Manual 50. Here we shall expand our understanding of this vital matter.

Competition as a Cause of Failure. One of the many factors attributed as a cause of failure is competition. But the fact is that business men are too often inclined to blame competition for a result which really comes from lack of intelligent management, or from misjudgment. Competition is stimulating, but only to those who have the ability to cut their costs and get the sales volume necessary. In this connection, Harvey S. Firestone says in his memoirs:

"Competition rarely puts anyone out of business—a man usually puts himself out of business either by not making a good article or by wrong methods in sales or finance."

This supplies one of the strongest arguments there is in favor of all-round business training. Competition is truly the life of trade, but it is likewise death to enterprises which do not know how to meet it. The history of commercial failures in this country shows that the vast majority are due to causes which truly competent management would have understood and turned to a profit.

The fully trained business manager watches his competitors almost as closely as he watches his own business and, recognizing the need for organization flexibility, changes the financial and operating structure of his business whenever this is necessary to assure the earning of future satisfactory profits. When it becomes apparent that conditions over which the management has no control make it impossible to earn profits in the face of competition, the trained executive recognizes the facts, looks them squarely in the face, and takes one of the three courses open to him:

1. Effects a combination with one or more competitors.
2. Makes some radical change in product and marketing plan which takes him into a less competitive field, or if these are both impossible
3. Liquidates the business with the least possible loss.

Changes in Consumer Demand. Another, tho less prevalent, cause of failure is the changing demand of consumers. We have a good example of this in the transition of many companies from the manufacture of carriage accessories to that of automobile accessories. As another case in point, it took real foresight, considerable initiative, and careful conservation of resources, to change from the manufacture of solid tires to pneumatic tires—yet the outstanding companies did this without going thru the troubles of forced reorganization.

Governmental restrictions on the manufacture of certain goods also have served as a cause for failure. Nationwide prohibition has eliminated many manufacturers who were formerly in the brewing and distilling business. Many of these manufacturers saw the approach of prohibition and made plans to adapt their plants and equipment to the manufacture of other products. As a result, we see many former breweries in a much better financial position than they were before adverse governmental legislation.

New laws restricting business are not ordinarily imposed so rapidly as to prevent the business man from foreseeing them and readjusting his business to comply with them.

The recognition of this principle makes it incumbent on the business man to watch closely the development of political thought, as a means of anticipating future legislation.

Uncontrollable Economic Causes of Failure. We saw in Executive Manual 3 that the fluctuations of the business cycle are uncontrollable by the individual business man. We also saw that the success of a business is largely de-

pendent on the degree of accuracy with which the business executive interprets the business cycle and gauges future economic trends.

The executive who is able to interpret economic trends is in a position to expand or contract his internal organization or to alter his financial policy in time to weather a storm or to take fullest advantage of the opportunities afforded.

A company which carries adequate secondary reserves is in a good strategic position to operate in times of financial disturbance.

Funds are more readily available in times of general prosperity than in periods of depression. Credit is usually cheapest following a period of depression—during the early stages of business recovery. An understanding of the operations of the business cycle, as explained in Executive Manual 3, enables the trained executive to carry out changes in his financial program when conditions are most favorable.

Insufficient Income as a Cause of Failure. Many business concerns start out without having made an exhaustive market analysis to determine in advance the probable amount of income from sales. Financial preparation may be adequate but the volume of business which they actually get does not afford them an adequate return on their investment. This condition often obtains in industries which manufacture products that depend on public acceptance rather than on a basic need. If general public acceptance cannot be won, the most intensive sales efforts may be of little avail, and either drastic paring down of invested capital or a change to another line of business activity may become necessary.

Many businesses have failed thru trying to enter a field which is already well served at a low cost to the consumer.

We have a good example of this in the case of a New York wholesale dry goods concern which had an enviable

record of success over a number of years. This concern, finding itself confronted with growing competition and the increased buying power of retailers (especially of chain-store organizations), decided to enter the retail field and to establish adequate outlets for its goods.

Its first step was to finance and start a chain of retail dry-goods stores which would buy their supply of goods from the parent house. This plan might have been successful in the days when the average retail store had very small buying power; but, at the time the wholesale company's chain was started, the purchasing power of many competing retailers was such that they could deal directly with manufacturers and thus eliminate the jobber profit entirely. As a matter of fact, this ability of the retailer to deal directly with the manufacturer, either alone or in a buying association, had been one of the main reasons for the decrease in the wholesale company's business.

The chain started off well but it wasn't very long before its management saw that it could not compete successfully with retail dealers who were buying directly from manufacturers at prices nearly equal to those paid by the wholesale company. When the parent wholesale company had added its profit to the cost of the goods, the retail prices which the chain had to charge to realize an adequate return on the investment were so high that retail customers would not pay them. The high prices made it impossible to obtain the volume of sales anticipated.

It is apparent that, under the existing conditions, it would have been better for the wholesale house to have reorganized its business as a retail chain-store corporation. The methods it did adopt brought about ultimately a much more drastic reorganization. For instead of undergoing a reorganization while there was yet time to bring about the desired conditions, the company adopted questionable methods to stave off failure. Notes were issued over the signatures of the chain-store branches and discounted by the treasurer in New York without the

knowledge of the branch managers. When no more funds could be raised by this expedient, the parent organization was forced into bankruptcy.

Most financial observers believed that the assets of the branch houses would take care of nearly all the liabilities, but when a thoro audit of the books was made, it was found that the estimated excess of liabilities over assets was about three times what had been expected. This condition, of course, called for drastic action. As a result of the reorganization which followed, a new corporation, entirely divorced from the parent company, was organized to take over the chain of retail outlets. After refinancing, the chain was in a favorable position and had excellent prospects of success. It could buy directly from manufacturers and was thus on an equal footing with its chief competitors.

Overcapitalization as a Cause of Failure. Overcapitalization is a term which is used in two senses, and in either sense it describes a condition which may result in business failure. In the more usual meaning of the term, a company is spoken of as overcapitalized when its capital structure is larger than is warranted by the earning power of the business; in the second sense, overcapitalization is used to signify an excess of cash capital. Let us consider the consequences of each.

A top-heavy capital structure is a result, as a rule, of an inflated valuation of the assets exchanged for stock when the company is organized. When forming the new corporation, the promoters may turn in a plant in exchange for stock, at a value which is considerably higher than the plant's real worth; or the organizers may receive for their services stock whose par value is thousands of dollars higher than the real value of these services as an asset to the company; or bonds may be placed with some underwriter at so heavy a discount that the difference between the cash received and the bonds issued represents a substantial overcapitalization.

Now dividends and interest must be paid on this "water" capitalization, at exactly the same rate as on the outstanding stocks or bonds which represent real assets and are of the same classes. It is obvious that the more the "water" in the capital structure, the more thinly must be spread the earnings which the real assets earn. Very often the directors of a company which is thus overcapitalized, in their eagerness to make a favorable dividend showing, will feel forced to pay out all or practically all the net earnings as dividends, thus milking the company of its working capital.

Every dollar of outstanding capital should be represented by assets whose earning power justifies the value at which they are carried on the company's books.

Overcapitalization, in the sense we are using the term here, will also result when the capital assets suffer a serious and permanent loss in earning power.

How Losses Create Overcapitalization. We have a good example of overcapitalization as a result of loss (and also of its remedy), in the history of a prominent electrical manufacturing company. The management of this concern was fired with a zeal for world-wide expansion, and endeavored to develop foreign markets on a large scale. It sank so much money in the attempt that profitable earnings on the investment were no longer possible. As a result of this unwise expansion, a reorganization was put thru whereby stockholders were induced to turn into the treasury one-half their shares and bondholders were persuaded to take drastic cuts in their income rates. Thru the resale of the stock turned in by the stockholders, the company was able to raise enough cash to operate on, and by adopting a conservative operating policy it was eventually able to earn satisfactory profits on its capitalization.

On the surface, the above case would indicate that shortage of cash was the main reason for reorganization.

It must be remembered, however, that this shortage of cash was caused by paying high fixed charges on capital which had no earning power. All this capital represented money which had actually been expended in attempting to build up new markets. But these attempts failed and much of the capital represented nothing but water; to that extent this company was overcapitalized.

How to Use an Excess of Capital. Overcapitalization in the sense of having an excess of capital can also be an underlying cause of failure. If a company has a lot of capital lying idle, its directors too often feel that the excess capital must immediately be put to work, and they enter hastily upon extravagant expansion plans, unmindful of the fact that—

Healthy growth takes time; it cannot be forced unduly.

If a company finds itself with more cash on hand than it is likely to need as working capital or as reserve funds, it is, as a rule, good policy to purchase some of its own bonds or preferred shares and hold them in its treasury. This reduction in the securities outstanding will, of course, permit the payment of proportionally higher dividends on the shares which are in the stockholders' hands.

The callable provisions inserted in some bonds and preferred stocks at the time of their original issue make it easy to invest excess moneys in this way and avoid overcapitalization and the ill effects resulting from it. Foresight and constant vigilance are needed in formulating and executing financial plans.

The farsighted executive will make provisions against future overcapitalization as well as against future undercapitalization.

Excess Floating Debt May Cause Failure. The average business man is too often inclined to accept unquestioningly the statistics of failures—statistics which purport to show that lack of working capital is one of the principal causes of financial insolvency and financial failure. Lack

of working capital, however, is usually but an *apparent* cause, a surface indication—a result of causes which are less apparent. We have discussed some of these causes; let us now see how an excess of floating debt may lead to a poor working-capital condition, and this in turn to financial distress and ultimate failure.

Widespread prosperity is conducive to unwise expansion. When a period of prosperity occurs, many a business is inclined to take profits and convert them into fixed assets when, under a wiser financial policy, these profits would have been kept as working capital and the new fixed assets would have been financed by bonds or new capital stock. Thus, while the total assets may be increasing in value, the working capital may be stationary or even decreasing in amount, with the ratio of working capital to invested capital becoming smaller.

When this ratio tends to decline, the trained executive sees in it a danger signal and takes it as a definite warning. One of the chief causes of the financial embarrassment of the Colbrook Mills—the New England textile firm whose case was described in Executive Problem 48—was the expansion policy which put too great a proportion of the company's capital into fixed assets. "Too much in bricks and mortar!"

As the fixed assets of a business increase, there should be provision for enough working capital to handle the volume of business necessary to permit adequate earnings on the total capitalization.

This is a restatement of a principle so forcefully illustrated many times over in the section on financing a business. Underlying a shortage of liquid capital there are always causes which may be traced back to the original financial program or to policies adopted later for current financial operations.

Danger of Relying Too Much on Current Borrowing. Ordinarily there is a considerable period elapsing between the time a capital investment is made and the time the

actual profit on the investment is realized. The amount of operating capital needed to finance the enterprise in the interim is largely determined by the length of time elapsing between an investment and the receipt of profits on it.

Let us take the very usual case of a salesman taking an order for some goods which cannot be filled from stock. To fill this order, materials must be purchased and labor paid to finish the articles, and it may be several months before the order is paid for. You can readily see how the outgo of funds, especially at the start, tends to keep ahead of the receipts.

It is for the purpose of supplying operating capital needs during this interim that much commercial short-time borrowing is done. This use of borrowed capital is perfectly businesslike, except for the tendency of many businesses to lean too heavily on short-term borrowed-capital support. Financial reorganization would never have been necessary for large numbers of businesses if they had followed the sound principles in regard to the financing of current operations, which are given in Executive Manual 45.

Results of Expansion Financed by Short-Time Loans. The danger of accumulating too great a floating debt (current liabilities) is well illustrated in the following case. A men's clothing manufacturer started in business as soon as woolens were available for civilian use after the War. He made suits of good quality and met with a ready demand for his product. This, you will remember, was during a period of general prosperity all over the country.

This manufacturer had visions of a large national organization and plowed back the profits of the business into expansion of his plant and marketing facilities. Everything was going fine and the prospects for steadily increasing profits looked good. He felt that he could

expand even faster by stretching the credit terms on the cloth he used, and thus conserve his cash for current operating expenses. He therefore arranged for fairly long-term credits on his cloth; and when cash didn't materialize in time to pay the bills, he floated a few notes. He then became so obsessed with the profits which could be made on borrowed money that he greatly increased his short-term obligations.

Then came the sudden contraction of bank credit in the crisis of 1920. This manufacturer's collections had been lax and the banks wanted their money. His suppliers—the mills—refused to extend more credit until his outstanding accounts were paid. He was doing everything to raise cash to pay his most pressing creditors as conditions grew worse. His collections dwindled and his company passed rapidly thru the stages of financial embarrassment and distress into actual insolvency.

If this manufacturer had been willing to adopt a conservative program of expansion financed with a long-term bond issue instead of notes, thus conserving his cash, he might have weathered the storm. In fact, during the reorganization, a bond issue was floated with the plant and machinery as security. However, this refinancing was not sufficient to save the manufacturer's interest in his business. The amount of short-term obligations was so great that the creditors had to take over the business. Since the manufacturer had only a stockholder's equity, which was "frozen out" by this reorganization, he lost his presidency and had to accept a salaried position in the reorganized company.

Incompetence, the Chief Cause of Failure. From a management standpoint, incompetence is the lack of knowledge of fundamental business principles or the lack of ability to apply these principles in active management.

Executive Manual 50 contains a chart which shows the causes of failure as analyzed by Bradstreet's, one

of the two large credit-rating agencies. In this chart the most prominent cause for failure is shown to be incompetence. But the word "incompetence," as used by Bradstreet's, has a narrower meaning than we have given it. Incompetence really includes more causes of failure than those listed on the chart just mentioned, as pointed out in preceding pages.

Incompetence may be collective or individual. If incompetence is individual, if it is centered in one executive in an organization, he can be removed; but if incompetence is a general condition among the executives or workers, if it is collective, drastic operating reorganization is necessary to eliminate it.

We are often inclined to blame an individual worker for incompetence when the fault lies in the fact that the man does not know what to do, when the responsibility for the worker's incompetence is really on the person in charge.

Where incompetence develops in the ranks, an analysis should be made as to underlying causes before any drastic change in the personnel is made.

If it is conclusively determined that the fault lies in the inability of certain individuals to perform their duties properly, the management should take steps to supply that ability—by giving the necessary training, or by transferring the workers to jobs they can perform, filling their places with more capable workers.

Many of the causes commonly given for failures, such as competition, operations of the economic cycle, and lack of working capital, are really chargeable directly to managerial incompetence, for the competent manager will find new ways of meeting competition, will be prepared for changes in economic conditions, and will provide sufficient working capital by following sound financial procedure. Thru his all-round knowledge of production, of sales, of finance, of organization, of managing men, he will insure himself and his business against

financial failure, and he will increase his earnings and the profits of his business; at the same time rendering a service to others that cannot be measured in dollars alone.

* * * * *

One additional phase of training for executive work remains. It is of great importance in rounding out any man's training for unusual success as a business manager. You saw clearly the need for it in your analysis of the problem of organization and reorganization. Your mastery of legal problems, as covered in the succeeding manuals of this training service, will give you many decided advantages. You will recognize the truth of this statement as soon as you take up Executive Manual 93.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles or **ORGANIZATION AND REORGANIZATION**, presented in **Executive Manuals 86-92**, firmly fixed in mind. This will help you handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. Dahlin and Witwer are young men who have had successful experience in the automobile business—Dahlin as a salesman, Witwer as manager of a service and repair garage. They want to start an enterprise for the sale of cars and accessories and the operation of a service and repair garage. But they have only \$2,000 between them to invest. They persuade William Jenkins, a man of considerable means, to form with them a general partnership and to contribute \$20,000 to the business. The partnership agreement provides that Jenkins is to take no active part in the business, and is to share equally with the other two in the profits and losses. If the business later fails and has \$15,000 of unpaid debts, will Jenkins be liable to the creditors for the full \$15,000?		
2. If Dahlin, Witwer, and Jenkins had formed a joint-stock company instead of a general partnership, would Jenkins' liability for the unpaid debts of the concern be so great?		
3. Would the joint-stock company be terminated by the death of Jenkins?		
4. Do you know the most important characteristic in which a joint-stock company differs from a corporation?		
5. Suppose Farren and his associates, in the organization of the Paramount Motors Company (Executive Manual 90), had decided to form a common-law trust instead of incorporating. If you had \$5,000 that you wanted to invest in the enterprise, would you join the undertaking if the trust agreement provided for the annual election of trustees by vote of the holders of the trust certificates?		

	Check	
	Yes	No
6. Would a complete organization chart prepared for all the workers of the Wittmack Publishing Company (Executive Problem 64) be of material assistance to Mr. Wittmack in carrying out his marketing program?		
7. A promoter contracted, in the name of a proposed corporation, for a piece of land which he represented as being the site selected by the organizers for the corporation's factory. But when the charter was issued, the directors chose another site. Can the owner of the land look to the corporation for damages?		
8. Davis, Jones, and Henning decided to form a small specialty-manufacturing corporation. The factory was to be located in San Francisco and sales were to be made only in the local market. The organizers decided among themselves to take out a charter in Arizona because of the small incorporation fee and franchise tax in that state. Was this sufficient reason for their decision?		
9. It is proposed at a stockholders' meeting of the Maxon Company that the following by-law be adopted: that the minimum dividend rate on the common stock shall be 5 per cent per annum. If you were a stockholder, would you favor the adoption of this by-law?		
10. Would you advise the preparation of an organization chart as a helpful factor in speeding up collections for the Portland Branch of the General Wholesale Grocery Company (Executive Problem 54)?		
11. In March, 1926, the Fairfield Oil Corporation floated an issue of 6 per cent debenture bonds and sold them to the public at par. Concurrently the Lake Dearborn Apartment Hotel Company sold an issue of first-mortgage 6½ per cent bonds at par. Both issues have the same maturity dates. Do you see what may explain the difference in interest rates?		
12. The first-mortgage bonds of the Wellington Electric Manufacturing Company have been defaulted, and the grace period has expired. Have the holders of these bonds the right to step in and assume control of the mortgaged property?		

	Check	
	Yes	No
13. The Parmelee Publishing Company has outstanding an issue of 7 per cent cumulative preferred stock (\$100 par), convertible at the holder's option into common stock at the ratio of one share of preferred to three of common. The dividends on the common stock have recently been increased to \$3 per share per annum. Are there any advantages to the company if a large proportion of the preferred stockholders exercise their conversion rights?		
14. A manufacturing business was being reorganized because sales had dropped off sharply, largely as a result of inability to fill orders on time. It was suggested that the operating reorganization start by effecting co-ordination between the sales and production departments. Does this appear to be the proper procedure?		
15. In reorganizing the Breitung-Haskwell Advertising Corporation—described in Executive Problem 65 and Executive Report 65—which plan of control would you adopt? Line ☐ Line and Staff ☐ Functional ☐		
16. The Gordon-Dale Publishing Company has been in business for a number of years, during which time it has pursued a very conservative policy as to growth, and has built up a large cash surplus. The stockholders have just approved an increase in capitalization, in contemplation of a major expansion in sales and production activities. Miller, the general manager, learns that a certain executive with considerable experience in the publishing business is seeking a new connection. Miller wants to secure this executive at once, and find a place for him later. Dale, the vice president, opposes this because the expansion plans have not yet been definitely worked out. If you were the president, would you agree with Dale? ☐ or with Miller? ☐		
17. George C. Hartman had built up a successful tho a comparatively small business in the manufacture of auto bows—supports and framework for collapsible auto tops. He knew the business thoroly and exercised direct		

	Check	
	Yes	No
control over all the operations. His banker, an old friend, saw the business of the Hartman Corporation falling off on account of the increasing popularity of closed cars. He suggested to Hartman the advisability of taking in an executive familiar with another line of business to which part of the corporation's plant and equipment could be adapted. He recommended an internal reorganization, but Hartman immediately protested against changing the plan of control. Was the banker likely right in his recommendation?		
18. A reorganization had just been undergone and everything was going well except in the traffic department, where the manager said he had too much work to handle. The reorganizer told him that he had carefully figured everything out in advance, and that if the manager couldn't handle the job, he had better look for another one. Is this the correct way to handle such a situation?		
19. The Blackford Electric Company has outstanding an issue of \$500,000 bonds, secured by a closed first mortgage on its plant and equipment, which is carried on its books at a value of \$1,185,000. During the last two years, earnings have been diminishing, and production and sales costs increasing. While interest charges on the bonded debt are not high, total interest charges have mounted considerably, because the company has had to borrow heavily from the banks. No dividends have been paid on the capital stock for several years, since earnings have been barely sufficient to meet interest payments and other fixed charges. The management is of the opinion that if additional permanent capital can be obtained to finance present operating requirements and to broaden the company's market, the company will be able to earn substantial profits and to pay dividends again; otherwise a receivership will be necessary.		
A firm of investment bankers suggests that a voluntary reorganization be effected, whereby the present stockholders will surrender half of their holdings. The treasury stock thus created is to be sold to the public for enough to supply the additional permanent capital needed. Does this sacrifice appear to be better for the protection of the stockholders than to let the company go into a receiver's hands?		

20. The M. V. & I. is a short-line railroad whose earnings have been steadily decreasing for a number of years. It is strategically located, however, in this respect. It connects with two major trunk lines, either of which would materially benefit thru acquiring it. The capitalization of the M. V. & I. consists of \$1,500,-000 of 5 per cent bonds secured by a first mortgage on the entire property, \$900,000 of 6 per cent collateral-trust bonds, \$500,000 of preferred stock, and \$1,950,000 of common stock. The company is now in the hands of a receiver, having been unable to meet all of its fixed charges. The stockholders' reorganization committee formulates a plan to reduce fixed charges, whereby the first mortgage bondholders would be given, in satisfaction of their claims, \$750,000 in new first mortgage bonds bearing 6 per cent interest, and \$1,000,000 in new 6 per cent income bonds; and the collateral-trust bondholders would be given \$450,000 in new 7 per cent preferred stock and \$450,000 in new common stock. With a receiver's sale imminent in the event that a satisfactory reorganization plan is not worked out, is the stockholders' proposal likely to win the approval of the first-mortgage bondholders?	Check	
	Yes	No

Executive Problem 92

THE STAFFORD FINANCIAL REORGANIZATION

Giving a Sick Business a New Lease on Life

UNDER THE LASALLE PROBLEM METHOD



SOMETIMES a business gets to the point where only strenuous measures will bring it back to that healthy condition which enables it to "buck the world and make a go of it."

What finer accomplishment is there than to save a business from the scrap heap? Many of the foremost leaders in American business gained their reputations from their ability to work out reorganizations that have stood the test of time and service.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

FOREWORD

We are presenting here the interesting account of the difficulties which brought a formerly prosperous business concern to the brink of failure. This problem, with the working paper and the executive report, is in the form of an appendix to this manual on reorganization, in that it describes in detail a typical case and shows how the principles of reorganization are applied.

We are not going to ask you to devise a complicated plan of reorganization; instead we are going to show you how to analyze the problem for yourself and consider some of the main features which were proposed to remedy the situation. In the executive report we will discuss the merits of the various proposals made by the interested parties, analyze the efforts at compromise, and describe fully the plan that was finally adopted.

THE STAFFORD FINANCIAL REORGANIZATION

The Stafford Automobile Company was organized in the first decade of the twentieth century by two brothers, pioneers in the motor industry. These two men, having grown up with the industry, were able to manufacture a car that took its place well up in the ranks of quality cars. Stress was early placed on quality rather than output, and while the Stafford was not in the highest price class, its appeal was mainly to people of some means.

The business grew, not rapidly, but steadily. Earnings were good, the stock was closely held, 90 per cent of it in the Stafford family, and a considerable surplus was built up. This surplus was invested in the business as additional equipment and working capital.

At the close of the War the Staffords felt that they had reached a position where they were warranted in manufacturing on a much larger scale. The Stafford factory was located in a small but thriving city in one of the central states, a few hundred miles from the great automobile manufacturing district. It was one of the chief industries in the town and the people regarded it with proper local pride. But pride was not all they had. They had money, too, for the town itself was located in a rich farming and manufacturing district.

New Plant Built. The Staffords made their plans to build and equip a new factory building. This they proposed to finance partly out of accumulated earnings, partly thru the sale of \$500,000 of 7 per cent cumulative preferred (voting) stock, and partly thru an issue of \$300,000 of 15-year first-mortgage bonds. A stock dividend was declared, bringing the common stock from a stated worth of \$500,000 to \$1,000,000. The Stafford family subscribed to \$250,000 of the preferred stock; the remainder of the issue was floated thru a firm of invest-

ment bankers, with the co-operation of the local banks, and most of it was placed locally. Arrangements were made with the banks to increase the company's line of credit.

The new plant was opened about a year later. To control more effectively the sales of the car, the company established a number of branches in the principal cities of the country. Output was increased to about 3,000 cars per annum.

Prior to the building of the new plant, the company's net income, before deducting for interest, had been running between \$150,000 and \$250,000. It dropped to \$100,000 during 1920, the year the change was made to the new plant, but picked up again the next year, despite the general business depression. Sales and net operating income increased further during the next year but without the beneficial effects that usually accompany such a condition. No dividends were paid on the common stock after 1919.

Problems Faced After Expansion. The new factory had cost more than had been anticipated, so that working capital was far short of requirements. In fact, the company's financial position was becoming weaker and weaker. The two Staffords, who had been the active managers in the old days, were away much of the time on pleasure trips. In fact, one of the brothers had practically taken up his residence on the Pacific coast and had been out of touch with the business for several years.

With this sort of absentee management overhead mounted and selling costs increased. Borrowing had to be resorted to more and more. The bankers finally demanded that more capital be put into the business.

Early in 1923, an additional \$500,000 issue of preferred stock was put on the market. This seemed to be an opportune time to sell stock, but the company found it difficult, mainly for two reasons. One was its weakened financial condition; the other was that because of growing competition for sales thruout the whole automobile industry, the company had not yet succeeded in bringing its sales up to plant capacity, and this made overhead expenses per car too high. Only \$350,000 of the new preferred issue was placed, and this at an unlooked-for high cost.

With the proceeds from the stock sales the current indebtedness was cut down and the cash account increased. At the same time a part of the current indebtedness was funded into an issue of 7 per cent debenture notes to be retired out of income at the rate of 33 1/3 per cent a year for the next three years.

Unfortunately, this arrangement proved only a makeshift. In the effort to bring sales up more nearly to plant capacity, and be-

cause of keen price competition, the management decided to reduce the price. This brought the open models out of the \$3,000-\$4,000 price class for the first time. Sales efforts were increased and a heavier production planned. Large inventories were accumulated.

The net result at the end of nine months was lower profits, an accumulation of used-car trade-ins at the branches, top-heavy inventories, and increased current indebtedness. Adding further to the complications came the death of the younger Stafford in a railroad accident. The other brother was very ill in California and unable to resume his business duties.

Bankers Ask for a Reorganization. The bankers, who were the company's chief creditors, decided that a reorganization was the best solution to the difficulties. They felt unwilling to extend more credit or to extend the payment on the first installment of debenture notes (soon to become due) as long as the present management was in control. They were further impelled to this decision by the threats of one of the company's large creditors to file a petition in bankruptcy.

The company's latest balance sheet showed the following financial condition:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 10,795	Notes Payable (Secured)	\$ 125,000
Notes and Accounts Receivable	147,362	Notes Payable (Unsecured)	243,133
Due from Branches.....	651,718	Accounts Payable	295,194
Inventories	1,502,446	Accrued Liabilities	17,465
Plant and Equipment....	1,280,522	First Mortgage Bonds (due 1934)	300,000
Deferred Charges.....	39,876	3-year Debenture Notes	436,000
		Preferred Stock	850,000
		Common Stock	1,000,000
		Surplus	365,927
	\$3,632,719		\$3,632,719

The items on the assets side of this balance sheet were shown at their worth to a going concern. What they would bring under forced sale was problematical. The liabilities amounted to a little more than \$1,400,000, leaving the stockholders' equity in excess of \$2,000,000. At first glance it would seem that the preferred stockholders had a substantial equity. It was generally conceded, however, by those familiar with the business, that a forced liquidation would cause so great a shrinkage in the assets that little or nothing would be left for the stockholders after all claims were paid.

The bankers sounded out the other creditors and found all but one agreeable to some plan for settling the claims part in cash

and part in notes. The creditor who was most insistent in his demands for settlement held a purchase-money mortgage for \$125,000, and unsecured claims amounting to \$40,000 additional. He was induced to withhold action pending negotiations for a reorganization.

Indebtedness to the banks amounted to \$679,133, of which \$436,000 was in 3-year serial debenture notes, and \$243,133 in short-term notes. The bankers proposed that a new corporation be formed to take over the assets of the company, to pay off the greater portion of the current indebtedness, and to assume the obligations remaining.

The Bankers' Plan. The proposition which the bankers made to the stockholders included these main features. The new corporation would have an authorized capital of \$2,000,000 apportioned as follows:

6,500 shares of 8 per cent cumulative preferred stock (\$100 par)	\$650,000
85,000 shares of Class A common stock (\$10 par)	\$850,000
50,000 shares of Class B common stock (\$10 par)	\$500,000

The present preferred stockholders were to subscribe to \$425,000 of the new preferred stock in the ratio of one share of new preferred for each two shares of old preferred held. Each shareholder so subscribing was to receive ten shares of new Class A common stock (\$10 par) for each share of old preferred (\$100 par). The Class A common was to be entitled to 7 per cent dividends (cumulative) ahead of any dividends on the Class B common, and to preference in the assets ahead of the Class B in event of dissolution.

The holders of the present common stock were to subscribe to \$200,000 of the issue of new preferred stock in the ratio of one share of new preferred for each five shares of old common stock held. Each shareholder so subscribing was to receive five shares of new Class B common (\$10 par) for each share of old common (\$100 par).

The new preferred shares were to be made nonvoting, and the Class A common stock given voting privileges only so long as 7 per cent cumulative dividends remained unpaid on it. Thus the old common stockholders would have an opportunity to regain control of the management eventually.

Twenty-five thousand dollars of the new authorized preferred stock was to remain unissued for the present.

The \$625,000 cash to be thus raised was to be used to retire the outstanding \$368,133 in notes payable and one-third of the three-year debentures, \$145,333. Notes to be paid immediately thus totaled \$513,466, leaving \$111,534 to be added to the cash account.

The bankers proposed to grant the company open credit up to \$200,000, to be increased further as the remainder of the debentures were retired.

This, they pointed out, would leave the company with ample cash and credit, and would give the old preferred stockholders control of the company so long as their dividends remained unpaid. It was considered probable that dividends would be paid only on the new preferred at the start.

This plan was submitted to the common stockholders (the common being closely held, mostly in the Stafford family) and to the preferred stockholders' protective committee which had just been formed. Neither group (common or preferred) received the plan favorably.

The preferred shareholders objected to putting up additional cash equivalent to half their present holdings, and the common stockholders protested that the plan would practically freeze them out. The preferred stockholders pointed out that their \$850,000 holdings were represented by a \$2,000,000 equity and that the common stockholders were the ones to save the company. They maintained that operations had been carried on at a profit and that, given better management, the company would in time be able to reduce its indebtedness to a sum suitable to the bankers.

The bankers, for themselves and the other general creditors, countered with the assertion that the stockholders' equities would amount to very little in a forced dissolution, and that they did not feel justified in advancing more money. They pointed out that there was an immediate, pressing need for more cash, as the balance sheet showed. What, they asked, did the stockholders want to do? Let a dissatisfied creditor throw the company into bankruptcy?

The Preferred Stockholders' Plan. The preferred stockholders' committee thereupon suggested that the common stockholders take up the \$150,000 of unissued stock and that the banks fund \$300,000 of their 3-year debentures into 10-year sinking-fund general mortgage bonds to be secured by all the company's assets, subject to the \$300,000 first mortgage issue already outstanding. They further proposed that the common stockholders donate to the treasury \$300,000 (in par value) of their common stock, so that this treasury stock could then be given as a bonus with the new bonds (ten shares of stock for each \$1,000 bond). With this arrangement, they claimed the banks could dispose of most of the bonds for cash. Holders of the new bonds could then join with the preferred stockholders in naming a new management, since in combination they would control 11,500 votes against 8,500 controlled by the common stockholders

(7,000 common shares remaining, plus 1,500 newly acquired preferred).

The preferred stockholders further argued that under better management certain of the current assets could well be cut down and cash working capital realized therefrom with which to reduce the current liabilities. Also, they said, too much working capital was tied up in branches; the item \$651,718, "due from branches," should be cut down materially; used-car trade-ins should be liquidated and factory operations cut down until the new-car inventories at the branches were materially reduced; in fact, branches should be discontinued and dealer agencies established.

Negotiations Leading to a Compromise. On these points the bankers were disposed to agree, but they were disinclined to accept the proposals for new financing. They still insisted that the stockholders should arrange for the investment of needed cash capital. One of the bankers then suggested that the management services of Boyd Rothermel, a well-known automobile manufacturer, could be secured if the stockholders were willing to make the right kind of a deal with him.

Rothermel was sounded out. He expressed himself as willing to take over the reins and put in \$150,000 in cash, but only on condition that he and the bankers would be assured of uninterrupted control for five years; that he would have a five-year option of purchasing at least 80 per cent of the common stock at the rate of \$25 a share; and that total indebtedness should be reduced to \$850,000, not more than \$550,000 of which should be short-term (less than 5 years).

The bankers and the preferred stockholders' committee were anxious to obtain Rothermel's services and were agreeable to his terms. They thereupon entered into negotiations to decide on a reorganization plan that would be mutually satisfactory. Both sides were willing to make concessions.

Here was the essence of the problem. Short-term indebtedness amounted to \$1,116,792. This would have to be cut down by \$566,792. It was also agreed that cash should be strengthened by about \$90,000. Deducting \$90,000 from Rothermel's proposed investment, the negotiators applied the remaining \$60,000 to current liabilities and arrived at the net amount of \$506,792 which would have to be raised, in addition to Rothermel's contribution, to reduce the short-term debt.

In the working paper, you are to consider some of the main features of the plans discussed and of a compromise plan designed to accomplish the aims of the parties involved, and to satisfy their diverse interests.

